



Annual Report 2005

**MatrixOne, Inc. (NASDAQ: MONE)**, a leading global provider of collaborative product lifecycle management (PLM) software and services, enables companies to accelerate product innovation to achieve top line revenue growth and improve bottom line profitability. With world-class PLM solutions and a commitment to customer success, MatrixOne is focused on helping companies across the automotive, aerospace & defense, consumer, machinery, medical device, semiconductor and high-tech industries solve their most challenging new product development and introduction problems. More than 800 companies use MatrixOne's solutions to drive business value and gain a competitive advantage, including industry leaders such as BAE Systems, Bosch, Comau, General Electric, Honda, Johnson Controls, Linde AG, NCR, Nokia, Philips, Porsche, Procter & Gamble, Sony Ericsson, STMicroelectronics and Toshiba. MatrixOne ([www.MatrixOne.com](http://www.MatrixOne.com)) is headquartered in Westford, Massachusetts, with locations throughout North America, Europe and Asia-Pacific.



## Financial Highlights

<b>Fiscal Year</b>	<b>2005</b>	<b>2004</b> <i>(as restated)</i>	<b>2003</b> <i>(as restated)</i>	<b>2002</b> <i>(as restated)</i>	<b>2001</b> <i>(as restated)</i> <i>(unaudited)</i>
<b>Statements Of Operations Data</b>			<i>(in thousands)</i>		
Total revenues	\$ 124,054	\$ 109,577	\$ 105,021	\$ 118,949	\$ 139,438
Gross profit	69,564	60,136	55,191	61,274	86,103
Total operating expenses	90,162	73,903	85,010	97,597	90,136
Net income (loss)	(20,321)	(12,406)	(28,202)	(33,024)	4,467
<b>Balance Sheet Data</b>					
Cash and cash equivalents	\$ 107,677	\$ 118,414	\$ 127,665	\$ 139,642	\$ 156,349
Total assets	172,960	158,378	168,078	198,858	218,070
Total stockholders' equity	101,782	107,946	117,648	140,953	165,724

Shown above are just a few of the valued members of the MatrixOne global professional team, representing Sales, Marketing, Professional Services, Human Resources, Accounting, Product Development, Educational Services, Investor Relations, Customer Support, Administrative Services and Software Engineering. Pictured left to right are, Helen Thomas, Robert Hawley, David Dai, Karen Fitzsimmons, Janet Saxton, Barry Foster, Natalene Gorfine, Scott Simons, James Taris, Rade Zirilic, Anita McHugh, Brian Norris, Kristin Montbleau, Joe Musumano, Peter Gorny and Mark O'Connell.

## Dear Fellow Shareholder:

I am pleased to report that, during fiscal year 2005, more companies than ever before turned to MatrixOne Product Lifecycle Management (PLM) solutions to create a product development environment that would enable them to bring innovative new products to market to meet the needs of their customers and improve their financial performance. We drove growth throughout our business by leveraging our greatest competitive differentiators — the depth of our technology and implementations, our unique ability to collaborate with our customers and partners to bring new and innovative solutions to market, and our commitment to the success of our customers. We achieved growth in both revenues and market share, and successfully extended our leadership position in the fastest growing class of enterprise software — PLM.



*"The people and products of MatrixOne are powering some of the largest and most complex PLM implementations in the world... At General Electric, 60,000 employees in over 300 sites around the globe come to work every day accelerating new innovations from concept to customer with technology from MatrixOne. We have implemented the largest, most comprehensive PLM initiative in the history of Honeywell where 25,000 users in over 30 locations are collaborating to speed new demand driven products into the market. At Honda Motor Cars, we are fueling one of the most advanced new car initiatives in the world—enabling Honda to move new car ideas from the drafting table to the showroom faster than ever before."*

**Mark F. O'Connell,**  
President & CEO, MatrixOne

Some of our key accomplishments over the last year include:

- Total revenues increased by 13% to \$124.1 million
- We completed the strategic acquisitions of Synchronicity Software and Centor Software;
- Our customer base grew by nearly 30% with the addition of almost 200 new customers; and
- We introduced nine new PLM solutions into the market.

The growth we achieved over the past year reflects the growing recognition of the business value of PLM and the strength of our unique value proposition. Executives in every industry are looking for ways to solve practical yet critical product development challenges such as gaining market share by speeding innovative new products to market; driving synchronous product development

across electrical, mechanical and software design; lowering the cost of product development by both offshoring engineering to low-cost geographies as well as having greater reliance on suppliers for complex design and engineering work; and meeting more stringent regulatory and environmental requirements. For the past ten years our solutions and domain expertise have enabled our customers to develop more strategic and collaborative relationships with their suppliers. Our customers, which include industry leaders like BAE Systems, Bosch, General Electric, Honda, Johnson Controls, NCR, Nokia, Philips, Porsche, Procter & Gamble, Sony Ericsson, and Toshiba, are turning to our solutions to achieve real, measurable business value, such as three-year returns on investments in excess of 1,000% and payback periods of less than six months. These types of results are motivating more and more executives to invest in PLM solutions to improve their company's financial performance, which in turn is driving growth for MatrixOne.



**POSSIS®** *"MatrixOne PLM captures and provides immediate access to information, improves productivity throughout the product development process, captures regulatory compliance, facilitates multidisciplinary collaboration and captures critical corporate knowledge. The technology is a big step for us in our corporate strategy for growing our business in the years to come and introducing innovative life-saving products."*  
**Tim Anderson, Director of Engineering, Possis Medical**

*"MatrixOne was chosen as the foundation of our collaborative engineering efforts because of the high flexibility inherent in the system. It enables us to connect all suppliers of our business segment to our engineering team. As economic pressures continue to impact our product costs, Linde will need to continually look for an advantage to reduce product development costs while increasing product quality and time to market. In Matrix10, MatrixOne has delivered the collaborative environment needed for us to achieve these goals."* **Andre Schlotz, PLM Project Manager, Linde**



**CIMdata®** *"MatrixOne is one of a small number of companies that have become PLM Mindshare Leaders. They have achieved this recognition based on the size and scope of their implementations at customer sites, their technology, thought leadership, and overall presence in the PLM market."*  
**Ed Miller, President, CIMdata**

*"MatrixOne technology has enabled us for the first time to establish an integrated system for managing all business information and processes related to our product launches. Standard processes are automated and transparent to the end user. Data is easily accessible to team members anywhere in the world via the Web and workflow is efficiently controlled through the entire cycle. These PLM capabilities are of strategic value. They let us not only work faster but increase customer satisfaction. This allows Motorola Automotive to pursue more new business that undoubtedly will help increase profitability and market share."*  
**Rich Seehafer, IT Business Systems Analyst, Motorola Automotive Electronics & Communications Systems**



**MOTOROLA  
Automotive**

 **XAAR** *"With MatrixOne's PLM solutions in place, Xaar's engineers, key development partners and worldwide sales engineers can now track and maintain any number of design revisions and reduce the time it takes to communicate changes from one week to a minute - allowing them to focus on design and not design management."*  
**Rob Welford, Director of Engineering, Xaar**

*"With the increase in product and design information that we have to manage on a daily basis, it became clear that we needed a solution that will facilitate the global sharing and management of product information. In order for our business to continue to run at a high rate of efficiency and to continue producing error-free products and services for our clients, we needed a new infrastructure that could allow us to more easily and effectively share product information, and that would give us the option for future expansion. MatrixOne's PLM environment was able to offer us a way to solve these issues and to improve upon our existing processes."*  
**David Wang, Director of Information Technology, Comau Pico**



In fiscal year 2005, total revenues grew to \$124.1 million, an increase of 13% compared to \$109.6 million a year ago. Software license revenues, which are a key measure of success for any software company, grew to \$47.3 million, an increase of 22% compared to \$38.7 million a year ago. Service related revenues, a key indicator of customer satisfaction and future cash flow, grew to a record \$76.8 million, an increase of 8% from \$70.8 million a year ago. Our balance sheet remained very solid with no debt and \$107.7 million in cash and cash equivalents. Our results reflect the impact of our recent financial restatement which we completed after deter-

customer needs management, product portfolio management, and synchronous product development across electrical, mechanical and software design. As our customers' needs have evolved over time, so too has our approach to the market. Several years ago we reset the agenda for the industry by introducing an integrated set of Business Process Applications we call the Centrals, that package world-class product development processes with the extensive domain expertise we have gained over the last decade. These applications enable companies across all industries to solve common prod-

IN A RECENT SURVEY OF MORE THAN ONE HUNDRED CHIEF EXECUTIVE OFFICERS CONDUCTED BY THE NEW YORK STOCK EXCHANGE<sup>1</sup>, MORE CEOs CITED NEW PRODUCT INITIATIVES AS THE SINGLE MOST IMPORTANT DRIVER TO THEIR COMPANY'S REVENUE GROWTH OVER THE NEXT FIVE YEARS. WHILE SPENDING FOR OTHER SEGMENTS OF SOFTWARE SUCH AS ENTERPRISE RESOURCE PLANNING, CUSTOMER RELATIONSHIP MANAGEMENT, AND SUPPLY CHAIN MANAGEMENT IS EXPECTED TO REMAIN FLAT OR DECLINE OVER THE NEXT SEVERAL YEARS, MARKET RESEARCH FIRMS LIKE AMR RESEARCH<sup>2</sup> EXPECT THE MARKET FOR CORE PLM SOFTWARE AND SERVICES TO GROW FROM \$4.0 BILLION IN 2004 TO \$7.4 BILLION BY 2009. THE SIMPLE TRUTH IS THAT PLM HAS ALREADY BECOME THE FASTEST GROWING CLASS OF ENTERPRISE SOFTWARE AND IS EXPECTED TO REMAIN SO FOR YEARS TO COME.

mining that certain revenue, originally reported during the last six fiscal years, was accounted for improperly. During the restatement process, we were able to minimize the disruption to our Company while maintaining focus and executing on our vision for the PLM market. After making appropriate changes to our practices and controls, we believe we have emerged from the restatement process a stronger Company.

MatrixOne's overall growth was fueled by a record number of new customer wins including ABB Power Systems, Bosch, Comau, Elettronica, ITT Avionics, Luxottica, Tower Semiconductor, and Vicor. These customers join the over 800 companies before them that have adopted our solutions to drive new product development. In collaboration with our customers, we introduced a number of new solutions to the market that address our customers' evolving needs in such areas as materials compliance,

uct development challenges such as program and product management, supplier collaboration, and document management. We revolutionized the industry again this year by introducing a new set of solutions, which package vertical market expertise and our technology into industry specific solutions that we call the MatrixOne Accelerators. These Accelerators enable companies to meet the unique product development challenges of specific markets such as apparel, medical device and semiconductor by providing users with industry specific terminology, data models, work processes, reports, and role-based user interfaces. Based on the early response from our customers, we believe this approach will usher in a whole new era of customer adoption by enabling all companies to more affordably innovate with the advanced richness of solutions specifically designed for their industry.

<sup>1</sup> Susan Caminiti, New York Stock Exchange Magazine, "CEO Agenda 2006", August / September 2005.

<sup>2</sup> Michael Burkett, AMR Research, "The Product Lifecycle Management Applications Report, 2004-2009," August 29, 2005.

In the last year, we accelerated our leadership position in one of the PLM industry's key growth markets – high tech electronics. The vast proliferation of electronics-based content in nearly every new product introduced today – from automobiles to consumer electronics to children's toys – is driving demand for a new set of PLM solutions that can handle the complexity of the underlying product data and processes. In August 2004, we acquired Synchronicity Software, a leading provider of electronic design automation for design management, collaboration and intellectual property reuse solutions for the global electronics industry. In addition to add-

development, supplier collaboration and customer collaboration to help power some of the largest and most complex PLM implementations in the world to ensure the success of our customers. It is this dedication to excellence that is our true competitive differentiator and I thank each of our employees for their continued hard work and commitment over the last year.

Fiscal year 2005 was a year of significant progress for the Company. Moving forward, our strategy is to leverage our key assets to deliver profitable growth powered by the unique skills and expertise of the people at MatrixOne and the world class products and solutions

FISCAL YEAR 2005 MARKED THE LAUNCH OF OUR BUSINESS VALUE ASSESSMENT™ PROGRAM;

A PROGRAM GEARED TOWARD HELPING CUSTOMERS DEVELOP A DYNAMIC BUSINESS CASE AND ROADMAP

TO THE POTENTIAL BENEFITS FROM THEIR PLM INVESTMENT. CRITICAL BUSINESS METRICS AND RELATIVE

IMPROVEMENTS WHICH WERE CAPTURED AND BENCHMARKED INCLUDE:

- 20-75% TIME SAVINGS THROUGH IMPROVED EXECUTION AND AUTOMATION OF BUSINESS PROCESSES
- 35% AVERAGE REDUCTION IN PRODUCT LAUNCH COSTS
- 60% AVERAGE REDUCTION IN REQUEST FOR QUOTATION AND SOURCING COSTS
- 5-25% IMPROVEMENT IN TIME-TO-VALUE CYCLE TIMES
- 30% AVERAGE REDUCTION IN COST OF POOR QUALITY

ing rich new solutions and significantly increasing the size of our customer base, the acquisition of Synchronicity places us at the cornerstone of innovation for electronics-based products – the semiconductor. Building on this acquisition, in November 2004, we acquired certain assets of Centor Software, a leading provider of unique solutions that enable customers to comply with “green” product development initiatives such as Waste Electrical and Electronic Equipment (WEEE), Reduction of Hazardous Substances (RoHS) and End-of-Life Vehicle (ELV) regulations. I am pleased to report that we successfully integrated the people, products, and customers associated with these acquisitions.

Customers, new solutions, and strategic acquisitions were all critical components to our growth in fiscal year 2005, but our single greatest competitive differentiator continued to be the employees of MatrixOne. Our people are bringing new innovations together with best-in-class approaches to product

they have brought—and will continue to bring—to the market. At the centerpiece of that strategy we are focusing on delivering profitable growth by concentrating on the success of our existing customers and reaching new customers with our industry focused Accelerators. We will continue to drive success by leveraging the domain experience of our employees and partners.

On behalf of all of our employees, I thank you, our valued shareholder, for the continued confidence you place in MatrixOne.

Sincerely,



Mark F. O'Connell  
President and Chief Executive Officer  
MatrixOne, Inc.

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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**FORM 10-K\***

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

**For the Fiscal Year Ended July 2, 2005**

**Commission File Number 000-29309**

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**MATRIXONE, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**02-0372301**  
(I.R.S. Employer Identification No.)

**210 Littleton Road**  
**Westford, Massachusetts 01886**  
(Address, Including Zip Code, of Principal Executive Offices)

**(978) 589-4000**  
(Registrant's Telephone Number, Including Area Code)

Securities Registered Pursuant To Section 12(b) of the Act: **None**

Securities Registered Pursuant to Section 12(g) of the Act:  
**Common Stock, \$0.01 par value per share**  
(Title of Class)

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

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

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

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

As of January 1, 2005, the aggregate market value of the Common Stock held by non-affiliates based on the last sales price reported was \$336,329,210.

As of November 4, 2005, there were 52,092,859 shares of Common Stock \$0.01 par value per share, outstanding.

\*This document does not contain the information in Part III that was included in the Form 10-K filed by the Company with the SEC on November 9, 2005. The information required to be set forth in Part III of Form 10-K is included in the proxy statement for the 2005 Annual Meeting of Stockholders that accompanies this 2005 Annual Report. You may obtain a copy of the complete Form 10-K as filed with the SEC by accessing the website maintained by the SEC at [www.sec.gov](http://www.sec.gov), by accessing the investor relations section of the Company's website at [www.matrixone.com](http://www.matrixone.com) or by contacting the Company at MatrixOne, Inc., Attention of Brian Norris, Vice President of Investor Relations, 210 Littleton Road, Westford, MA 01886, or telephone number (978) 589-4040.

**MATRIXONE, INC.**  
**ANNUAL REPORT ON FORM 10-K**  
**FOR THE FISCAL YEAR ENDED JULY 2, 2005**

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## PART I

*This Annual Report on Form 10-K contains forward-looking statements that involve risks and uncertainties. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. MatrixOne, Inc. makes such forward-looking statements under the provision of the “Safe Harbor” section of the Private Securities Litigation Reform Act of 1995. In this Annual Report on Form 10-K, words such as “may,” “will,” “should,” “could,” “future,” “estimates,” “predicts,” “potential,” “believes,” “anticipates,” “plans,” “expects,” “intends,” and similar expressions (as well as other words or expressions referencing future events, conditions or circumstances) are intended to identify forward-looking statements. There are a number of important factors that could cause our actual results and the timing of certain events to differ materially from the results discussed, projected, anticipated or indicated in any forward-looking statements. These factors include, without limitation, the factors discussed in Item 7 under “Risk Factors” and elsewhere in this Annual Report on Form 10-K.*

### **Restatement of Consolidated Financial Statements**

In this Annual Report on Form 10-K we are restating our consolidated balance sheet as of July 3, 2004 and our consolidated statements of operations, stockholders’ equity, cash flows and related disclosures for the years ended July 3, 2004 and June 28, 2003 (the “Restatement”). We are also restating the condensed consolidated financial statements for: a) the four quarters of the fiscal year ended July 3, 2004; and b) for the quarters ended October 2, 2004 and January 1, 2005. We anticipate filing on the same date as this Annual Report on Form 10-K, our Quarterly Report on Form 10-Q for the fiscal quarter ended April 2, 2005, which will also include restated condensed consolidated financial statements. We anticipate filing an amended Quarterly Report on Form 10-Q for the second quarter of fiscal 2005 for the purpose of restating our condensed consolidated financial statements for the second quarter of fiscal 2005. Our Annual Reports on Form 10-K and the Quarterly Reports on Form 10-Q for fiscal 1999 through the first quarter of fiscal 2005 have not been revised to reflect the Restatement, and the financial statements contained in those reports should not be relied upon. Instead, the financial statements for fiscal 2004 and 2003 included in this Annual Report on Form 10-K should be relied upon. Refer to Note 3 in our consolidated financial statements in “Restatement of Consolidated Financial Statements” for additional information. We have also included under Item 6 “Selected Financial Data” restated Consolidated Statements of Operations Data for the years ended June 29, 2002 and June 30, 2001 and restated Consolidated Balance Sheet Data as of June 28, 2003, June 29, 2002 and June 30, 2001.

We have identified and reported “material weaknesses” to the Audit Committee of our Board of Directors and Ernst & Young LLP, our independent registered public accounting firm. Please see “Item 9A. Controls and Procedures” in Part II, and Management’s Report on Internal Controls over Financial Reporting on page M-1 in this Annual Report on Form 10-K for a description of these matters, and of the measures that we have implemented to date, as well as additional steps we plan to take to strengthen our controls.

### **ITEM 1: BUSINESS**

#### **General**

MatrixOne, Inc. is a provider of collaborative product lifecycle management (“PLM”) solutions. Our solutions enable companies from a broad range of industries to accelerate innovation and time to market and drive efficiencies into the product development processes by allowing for the collaborative development, building and management of their products. Our solutions bring together people, processes, content and systems throughout global value chains of employees, customers, suppliers and partners to achieve a competitive advantage by bringing the right products and services to market cost-effectively. By unifying and streamlining processes across the product lifecycle, companies can easily work on projects with parties inside and outside of their enterprises to achieve greater efficiency and profitability. In addition, our technology enables companies to adapt, react and scale quickly to address their ever-changing business requirements.

Our collaborative PLM solutions are based on our suite of software products, collectively referred to as Matrix10™. Our Matrix10 offering is a comprehensive and flexible PLM environment that consists of four components: the Matrix PLM Platform™, our Business Process Applications™, our Enterprise Integration offerings, and our MatrixOne Accelerators. These products allow our customers to address many critical business issues, including:

- Gaining visibility, control and measurement of product investments;
- Turning customer and market requirements into product design;
- Achieving synchronous design between the electronics, mechanical packaging and the software development involved in bringing a new product to market;
- Enabling global product development to harness the power of global resources;
- Collaborating with suppliers early in the product development process; and
- Ensuring regulatory compliance.

We also offer a variety of services that complement our PLM software. Our professional services personnel provide rapid and cost-effective implementation, integration and other consulting services. These personnel capture and model the specific business processes that reflect our customers' planning, design, manufacturing, sales and service practices while leveraging standard application functionality to reduce the total cost of ownership of our solutions. We also provide training, maintenance and customer support services to enhance the value of our products to our customers. In addition, we have a global network of systems integrators who are experienced in providing implementation and integration services to our customers. Many of our customers use their preferred systems integrators and others perform their own implementations.

We incorporated in Delaware under the name Adra Systems, Inc. in July 1983. In October 1997, we changed our name to MatrixOne, Inc. and in May 1998, we sold our legacy design and manufacturing software business, Adra Systems, to focus on our PLM solutions. Our principal executive offices are located at 210 Littleton Road, Westford, Massachusetts, 01886 and our telephone number is (978) 589-4000. Our Internet address is [www.matrixone.com](http://www.matrixone.com). The information contained on our website is not incorporated by reference in this Annual Report on Form 10-K.

### **Principal Products**

Our Matrix10 PLM environment provides organizations with a single, secure environment that eliminates the barriers to collaborative product development efforts caused by geographically dispersed organizations and value chains, multiple disparate systems and increasing security requirements. The Matrix10 PLM environment consists of four major components:

- The Matrix PLM Platform serves as the foundation for the Matrix10 PLM environment and includes the MatrixOne PLM Modeling Studio™, which enables organizations to easily configure processes, interfaces and data schema;
- Our Business Process Applications allow companies to improve the way they collaborate with internal and external teams, develop products and work with suppliers and partners and incorporate the best practices of some of the world's most innovative companies;

- Our Enterprise Integration offerings enable seamless data sharing between the Matrix10 PLM environment and third-party enterprise applications and tools, including leading mechanical computer aided design (“MCAD”), Enterprise Resource Planning (“ERP”) and electronic design automation (“EDA”) systems, and other popular productivity and office tools such as Microsoft Office; and
- Our MatrixOne Accelerators enable our customers to meet the unique product development challenges of specific industries like apparel, medical device, and high technology. Our Accelerator offerings bundle our Business Process Applications with specific industry language and terminology, data models and schema, pre-defined work processes and reports, and role-based user interfaces to speed deployment and ease user adoption.

### *Matrix PLM Platform*

The Matrix PLM Platform serves as the foundation for the Matrix10 PLM environment and is the underlying engine for Matrix10’s Business Process Applications and Enterprise Integrations. The Matrix PLM Platform provides the core capabilities that are used to build the essential functionality that helps our customers deliver better products to market, in a shorter time frame and at a lower cost.

The Matrix PLM Platform enables companies to model, automate and expedite business processes and content across global value chains of employees, customers, suppliers and partners. In addition, the Matrix PLM Platform gives our customers an easy way to receive and find product related information, securely vault and retrieve content, carry out tasks and communicate. It also provides security access capabilities and firewall-friendly, role-based access to only the most up-to-date and approved information.

The Matrix PLM Platform captures product and related process information simultaneously. Our customers can link and classify items, assign properties and provide role-based behavior. Unlike other web-based solutions, the Matrix PLM Platform’s objects contain detailed associations and services and can be changed and extended to by the customers to reflect changes in business needs over time. The content that is associated with these objects can come from many data sources, such as computer-aided design (“CAD”), product data management, ERP, customer order, visualization and other applications. The Matrix PLM Platform also provides the flexibility needed to model and improve business processes dynamically and adapt to ever-changing requirements that might be influenced by new suppliers, partners, acquisitions, and changes in technology and processes.

Some of the key features of the Matrix PLM Platform include:

- a standards-based, open environment that enables organizations to quickly and easily implement a PLM strategy across diverse environments, applications and platforms;
- a scalable architecture that enables the addition of database servers and industry standard web application servers for load balancing and supporting geographically dispersed deployments;
- file storage services that enable efficient file server distribution over Wide Area Networks (“WAN”) so large files remain close to the users who access them most frequently, while providing all users worldwide with easy and up-to-date access to those files as needed;
- advanced XML communication capabilities that enable easy integration to other enterprise systems and drive a standards-based approach for system-to-system communication;
- a common integration framework and application program interface (“API”) that ensures a standards-based approach for integrations to a wide range of authoring and design tools, including MCAD, EDA, ERP and office desktop tools;

- robust security and access capabilities supporting digital certificate technologies, single sign-on functionality and advanced lightweight directory access protocol integration to provide suppliers, partners and project teams with access to the information that is critical and specific to their job function; and
- dynamic modeling through the Modeling Studio, which is an integrated set of tools that enable customers to easily configure processes, interfaces and data schema to meet their needs.

### *Business Process Applications*

Our portfolio of Business Process Applications, also known as our “Centrals”, addresses the diverse needs of a wide range of both cross-functional and specialized roles within an organization. Incorporating the best practices of some of the world’s most innovative companies, our Business Process Applications allow companies to improve the way they collaborate with internal and external teams, develop products and work with suppliers and partners. Customers from a broad range of industries are using our Business Process Applications to transform their global value chain of employees, customers, suppliers and partners into a virtual enterprise, to both enhance product development efficiencies through interoperable processes that span concept-to-retirement and share process expertise across multiple companies and geographies.

Companies can start with any one of our applications and add additional applications at a later time without interrupting their business operations. These applications work in conjunction with the Matrix PLM Platform and our broad offering of Enterprise Integrations. Through the use of our Modeling Studio these applications are easily configured and customized to fit a company’s existing processes and business model. Together, these applications enable our customers’ users, across multiple divisions and companies to contribute to the successful delivery of products and services. Our Business Process Applications include:

- MatrixOne Designer Central™ enables geographically-dispersed design teams to securely collaborate as a single virtual team using capabilities such as embedded 2D/3D viewing, visual conferencing, workflow, and discussion threads. This application also allows product engineering to aggregate design files from multiple tools into a single master design to increase design re-use, promote early conceptual design with partners and decrease manufacturing errors from using out-dated designs.
- MatrixOne Document Central™ is a document management solution that enables companies to publish, share and find files with library classifications tailored to the various roles throughout the entire product lifecycle. The use of this application allows improved knowledge transfer between functional disciplines, which leads to increased intellectual property reuse and thus improved productivity.
- MatrixOne Engineering Central™ enables companies to manage the engineering product development process and its associated mechanical, electrical and software definitions of a product in order to automatically capture, communicate and synchronize product development content and the processes and participants in those activities. This application provides companies with visibility into the design change process and allows them to more efficiently hand-off product definitions from research and development to manufacturing, therefore improving new product time to market.
- MatrixOne Materials Compliance Central™, which is based on certain technology acquired in fiscal 2005 from Centor Software Corporation, enables companies to easily collect, organize, and report part-level materials and substance composition data. This application also comes with powerful discovery and analysis capabilities for compliance-related issues.
- MatrixOne Product Central™ enables companies to manage conceptual and commercial aspects of their products so that product features are based on customer needs. This application provides organizations with the ability to more accurately define a portfolio of products, features and configuration options based on specific customer and market requirements. By providing organizations with the ability to bridge the gap between marketing requirements and engineering design, this application allows companies to

improve part and design reuse by utilizing common modules across multiple product lines and to ultimately deliver the right products to market as quickly and efficiently as possible.

- MatrixOne Program Central™ enables companies to efficiently manage complex programs and projects that rely on extensive collaboration across global value chains of employees, customers, suppliers and partners. This application provides management with real-time visibility into a project's status in terms of process, costs and benefits and allows decision makers to easily determine which projects have the highest probability for success.
- MatrixOne Sourcing Central™ provides organizations with advanced online Request for Quote ("RFQ") functionality for complex engineered goods, allowing purchasing teams to collaborate with internal teams and external suppliers. This application helps companies streamline sourcing and product cycles, resulting in improved supplier bid response time and accuracy. Through this collaboration, suppliers provide meaningful input during product design, leading to more innovative products while having a direct impact on reducing cost of goods sold.
- MatrixOne Specification Central™ allows companies to capture and share data-rich product specification information such as packaging, raw materials and formulas with internal and external teams. This application provides organizations with standard templates to define product information, enabling them to more effectively control specification changes and encourage reuse, thereby improving product quality and reducing development cycle times.
- MatrixOne Supplier Central™ provides companies with secure access to outsourced design and manufacturing partners, enabling them to become an integral part of the design collaboration process. This application allows organizations to achieve both supplier and product quality through scorecards, part quality plans, certifications and supplier capability management. These capabilities enable companies to improve performance and predictability of both delivery and quality throughout their supply base.
- MatrixOne Team Central® offers a secure, structured, virtual workplace that enables ad-hoc collaboration for cross-functional, multi-organizational and geographically dispersed teams. Members can collaborate on documents and structured product data, such as parts and RFQs, which are created and managed with other MatrixOne Business Process applications, through discussions, notifications, alerts, online conferencing and workflow approval processes. Through improved global team collaboration, Team Central enables companies to reduce their time to market and improve product quality through better informed, timely decision making.

In August 2004, we acquired Synchronicity Software, Inc. ("Synchronicity") to provide solutions for companies that have high-value electronic content in their products. Together, MatrixOne and Synchronicity solutions enable large, global inter-company design teams to work together in real time to reduce design and development costs, leverage design expertise, improve quality, and accelerate time to market.

MatrixOne's Synchronicity ProjectSync® and DesignSync® increase individual, team and overall design chain productivity for companies which develop integrated circuits by tightly integrating threaded communications, issue tracking and management reporting with secure multi-site version control, release and configuration management and provides integration to major EDA tools, including Cadence and Synopsys.

MatrixOne's Synchronicity IP Gear™ Catalog and Helpdesk products provide a complete design reuse infrastructure for companies which develop integrated circuits by providing secure access and vaulting, an online catalog, a knowledge base, and a helpdesk.



## *Enterprise Integrations*

We provide a broad spectrum of integration products that offer application-to-application interoperability and provide simultaneous access to real time data. These integration products allow users to work in their native environments and exchange data and participate in the enterprise product development processes and decisions that are managed thru the MatrixOne Business Process Applications. These integration products also give users cross-application control of information and processes on both sides of their firewall.

We offer approximately 30 integrations and technologies to enable seamless data sharing between Matrix10 and other third-party MCAD, EDA, computer-aided software engineering applications and enterprise applications such as ERP, supply chain management and customer relationship management. We offer integrations to leading electronic hardware and software design tools which allow electronic and software engineers to access our enterprise-wide collaboration and business process applications while working within their chosen design tool.

The MatrixOne Adaplet Tool Kit includes enterprise application integration methodologies that allow ready-to-use solutions to integrate Matrix10 with other products.

## *MatrixOne Accelerators*

We offer several MatrixOne Accelerators to help our customers meet the unique product development challenges of specific industries. Our Accelerator offerings bundle our Business Process Applications with specific industry language and terminology, data models and schema, pre-defined work processes and reports, and role-based user interfaces to speed deployment and ease user adoption. Our Accelerator offerings include:

- The MatrixOne Accelerator for Apparel Design and Development™ enables apparel design companies to quickly and efficiently take products from design to sourcing to manufacturing to the customer. The solution offers broad and robust library management capabilities for organizing information such as colors, fabrics, trim, build instructions and other key elements to assist in reuse, standardization, collaboration and access control across the extended enterprise. In addition, capabilities for product design and planning, product costing, and strategic sourcing are included to encompass all aspects of the apparel design, development and production lifecycle.
- The MatrixOne Accelerator for FDA Compliance™ enables medical device manufacturers to achieve compliance of various Food and Drug Administration regulations throughout their product lifecycle processes, is designed to help significantly reduce product development costs and deliver products to market faster than the competition.
- The MatrixOne Semiconductor Accelerator for Design to Manufacturing™ enables developers of semiconductors to align marketing requirements to design outputs and achieve an efficient and timely flow of information across product design, manufacturing, assembly and test. This single repository to store data, documents, product configurations, change information and the associated business “best practices” gives semiconductor companies and their design chain partners the ability to better capitalize on emerging market opportunities.
- The MatrixOne Semiconductor Accelerator for Enterprise Project Management™ enables developers of semiconductors to manage complex projects and programs without leaving their proprietary design tool environment including offerings from Cadence Design Systems, Synopsys, Inc. or other proprietary tools environments. The solution offers developers the ability to manage globally dispersed project teams, attain predictable results with standard new chip introductions, and identify and facilitate projects that have the greatest opportunity for success.

## **Product Technology and Architecture**

Our PLM software is based on an Internet architecture utilizing open standards, Extensible Mark-up Language (“XML”) and web services technology and is enhanced by our proprietary technology for information integration and accelerated content delivery. Our software supports a variety of web application server architectures including BEA WebLogic, IBM WebSphere, Tomcat and SunOne Web Server. Our software supports any mix of Java-based distributed software architectures, including Remote Method Invocation and offers web services capabilities that allow companies to exchange messages and content with collaborating partners or industry exchanges. Messages can comply with the evolving standard vocabularies such as RosettaNet, cXML or BizTalk or independently defined vocabularies. The result is a scalable, flexible environment that is designed to eliminate the need for lengthy in-house development of complex custom software, thereby resulting in a lower cost of ownership. The software consists of an Internet platform, tailorable business process applications, and reusable business process components, integrations to third-party software and development tools.

At the center of our product architecture is the Matrix PLM Platform, which runs on Microsoft, UNIX and Linux operating systems. The Matrix PLM Platform forms the intermediary between the MatrixOne Business Process Applications or the MatrixOne Web user interface and the database and provides the necessary security, access control and application services to enable collaboration among multiple businesses. The Matrix PLM Platform is compliant with hypertext transport protocol (“HTTP”) and secure HTTP (“HTTPS”), providing the business model and XML representations to HTML and Java applications.

The Web user interfaces are Java and HTML based applications that can run on Microsoft Internet Explorer, Mozilla and other commercially available Web browsers. We support numerous operating systems including Windows 2003, Windows XP, Hewlett Packard HP-UX, IBM AIX and Sun Solaris, and MAC for our applications. We follow the Microsoft standards for Windows and the Internet standards for Java running with Microsoft Internet Explorer and Mozilla for certain platforms.

The storage layer includes support for multiple database servers including Oracle and IBM DB2. The storage layer also includes support for multiple file servers using standard file transfer protocols. We provide an enterprise application integration capability that allows data exchange with Web, legacy or incumbent applications.

We provide simultaneous support for multiple languages within the business model, which means that users of our software can work in different languages at the same time. We typically distribute our products in a single global release. Our products generally support Chinese, English, French, German, Italian, Japanese and Korean, and we intend to provide localization for additional languages as required.

We have entered into various platform alliances to enable us to take advantage of current and emerging technologies and open industry standards. Our platform partners include Oracle, Hewlett-Packard, IBM and Sun Microsystems. To promote the development, definition, adoption, implementation and growth of open standards, we work with several industry standards organizations, such as the World Wide Web Consortium, also known as W3C, RosettaNet, and the National Institute of Standards and Technology, also known as NIST, and a variety of industry-specific standards organizations.

## Services

We offer professional services, training, maintenance and customer support directly through our own services organization and indirectly through our third-party network. Our services organization is committed to ensuring that our customers successfully utilize our products. We believe we have a high customer satisfaction level as a result of a combination of our software implementation methodology, our large, global partner network and our professional services, training, maintenance and customer support programs. These programs are available globally and are designed to enable the rapid implementation of our products so our customers receive the benefits from their investment quickly. Our services are also designed to make our software easy to use and maintain, thus lowering ongoing costs to our customers.

### *Professional Services*

Customers may choose to implement our products by utilizing our professional services personnel or systems integrators or by themselves. Although implementation times vary with the scope of the software being implemented, the number of users and the number of geographic locations involved, certain applications can be implemented in as little as two weeks.

We offer implementation of our products through our services organization primarily on a time and materials basis. We provide for the transfer of the skills and knowledge necessary to allow our customers to assume responsibility for ongoing support and extensions of their implementations of our software products.

We also offer a wide range of other professional services, including program and project management, upgrade and optimization services for existing customers, and outsourced system support services. Our services organization consists of experienced professionals, many of whom have come from our customers' industries, which helps us to provide strong domain experience. We also have personnel with strong backgrounds and skills in business process re-engineering, data conversion, application integration, system architecture and project management.

### *Training*

Our educational services organization offers Web-based courses and training at our facilities located around the world or at customer locations. Our Customer Success Center, located at our corporate headquarters in Westford, Massachusetts, provides a comprehensive training facility. We also offer custom training for customers who demand instruction tailored to specific business or workforce environments. We also offer the Matrix Certified Professional program to systems integrators to assure our customers that their implementation teams include professionals who have received training in implementing MatrixOne software solutions.

### *Maintenance and Customer Support*

We offer maintenance and support services to our customers, alliance partners and systems integrators over the Internet or by telephone. Our toll-free telephone support is provided in multiple languages and is staffed by senior technical support personnel at several locations globally. Customers receiving support over the Internet have access to a full range of customer support services, including on-line problem solving, technical tips, answers to frequently asked questions and information about recently released and upcoming versions of our software. We provide our customers with personalized Web pages where they can access specific status reports, exchange information, register on-line for training and access an advanced knowledge base. Customers can also download new versions of our software over the Internet.

## **Customers**

We target large-to-medium size organizations throughout the world in growth industries. As of July 2, 2005, we had over 800 customers. Our installed base of customers represents numerous industries, including aerospace and defense, automotive, consumer products, financial services, high technology, machinery, medical devices and the process industries. No single customer accounted for more than 10% of our revenues in fiscal 2005, 2004 or 2003.

## **Geographic Information**

We have foreign subsidiaries in Austria, Canada, England, France, Germany, Italy, Japan, Korea, Singapore and the Netherlands. At July 2, 2005 and July 3, 2004, approximately 23.9% and 18.6%, respectively, of our total assets were located at our foreign subsidiaries. Approximately 35.8%, 40.9% and 35.4% of our total revenues for fiscal 2005, 2004, and 2003, respectively, were from our foreign subsidiaries and approximately 26.6%, 29.0% and 27.2% of our expenses for fiscal 2005, 2004, and 2003, respectively, were from our foreign subsidiaries. The remainder of our assets, revenues and expenses for the aforementioned periods were located at or derived from operations in the United States. Export sales from the United States accounted for approximately 8.8%, 6.9%, and 5.9% of our total revenues for fiscal 2005, 2004, and 2003, respectively. Refer to Note 12 to our Consolidated Financial Statements included in Part II, Item 8 in this Annual Report on Form 10-K for additional information regarding our geographic information.

## **Research and Development**

We pursue research and development through our internal engineering organization, third-party alliances and collaborative development efforts with our customers. Our internal research and development organization is divided into three product groups – platform, application and integration engineering – all which share common support groups. The focus of these three product groups is to broaden the global appeal of our products by improving our products' performance and scalability, expanding the use of our technology for data representation and collaboration, adding application services, increasing our distribution and replication alternatives, expanding our ability to integrate our technology with other applications used by our customers through technologies like web services, and extending our Internet security capabilities.

The platform engineering group is responsible for the development of Internet infrastructure products, such as our servers, dynamic business modeling engine, database caching and application integration. The platform engineering group researches and develops advanced architectures and technologies and closely follows industry developments and standards related to e-Business, the Internet, operating systems and software technologies. The application engineering group develops applications which our customers use to automate and streamline specific product development processes. The integration engineering group develops solutions that enable customers to link commercial and proprietary applications and legacy systems with our products. The application and integration engineering groups work closely with our sales, services and product management organizations and use the application expertise, domain experience and resources of our customers and alliance partners to develop and license applications and integrations. Quality engineering, user interface design engineering, release engineering and documentation groups support all three of our product groups and contract engineering companies provide additional engineering resources.

We maximize our research and development efforts by working closely with our alliance partners and customers to develop software applications and integration products. We have relationships with third parties to develop several of our applications, either through joint royalty relationships or on a contract basis. Under special contract and programs, we jointly develop best of breed software applications with our customers and typically retain the right to generalize the application for use with other customers. A critical focus of our research and development alliances is to increase the number and scope of customer-facing, supplier-facing and industry-specific applications and integrations. We have also established relationships with third-parties to develop several of our application products and the majority of our integration products pursuant to which we typically pay the

third party a royalty in connection with the license of these products by our customers. These relationships have allowed us to increase the number of application and integration products we offer to customers. We market, license and support our application and integration products through our direct sales organizations, alliance partners and distributors around the globe. We also work with our customers, systems integrators and complementary technology vendors to extend our integration products to supply chain management, customer relationship management, component supplier management and additional product data management applications. Our research and development expenses were \$29.1 million, \$23.0 million, and \$26.4 million for fiscal 2005, 2004, and 2003, respectively. We expect to increase our internal research and development efforts, as well as our third-party research and development, in fiscal 2006.

## **Selling and Marketing**

We market and license our software solutions through our direct sales organization, distributors and other business alliances. We have 17 sales offices in North America, six in Europe and three in Asia/Pacific. Our European, Middle East and Africa, or EMEA, offices are located in Amsterdam, the Netherlands with other offices in Coventry, England; Paris, France; Ismaning and Stuttgart, Germany; and Milan, Italy. Our Asia/Pacific offices are located in Tokyo, Japan, Seoul, Korea, and Singapore. We plan to expand our reach into the market through an expanded direct approach and a more focused solution selling indirect model targeted to high growth areas.

Most of the licensing of our software solutions in North America is made by our direct sales organization, although we are building our indirect sales channels to reach additional markets. In EMEA, we market, license and service our products through both our direct sales force and distributors, while in Asia/Pacific, we rely primarily on our network of distributors and resellers, with assistance from our direct sales force. Our network of domestic and international distributors and resellers is comprised of approximately 35 companies.

Our sales team, which includes our direct sales and technical professionals as well as our alliance partners, works closely with customers to identify short-term needs and long-term goals and then to develop a proposal to address customers' requirements. Our sales process is focused around understanding the needs of our customers and prospects, demonstrating the business value of our solutions and on providing solutions that clearly address their business challenges. The sales cycle for our products ranges from one to nine months based on the customer's need to rapidly implement a solution and whether the customer is new or is extending or upgrading its existing implementation.

We have a Customer Success Center, located at our corporate headquarters in Westford, Massachusetts, to support our global sales efforts. Our Customer Success Center provides the facilities necessary to help customers and prospective customers identify their goals and achieve their objectives through interaction with us. Our Customer Success Center is open to all our customers and prospective customers for strategy and technical meetings, as well as for training.

Our marketing personnel assist in generating new sales opportunities by creating various marketing programs, creating press and industry analyst interest and support, updating our Web site and hosting or sponsoring various events. We conduct joint seminars with key alliance partners and participate in a number of alliance partner-sponsored trade shows and industry events. We also provide speakers from our Company and our customers to represent us in a number of industry forums. We communicate regularly with our installed customer base via quarterly newsletters and by hosting customer conferences. Our public relations strategy is designed to convey our messages to appropriate audiences, and we reinforce this through our ongoing communications with a number of key industry analysts, financial analysts and members of the press.



## **Alliances**

The principal goals of our alliance program are to expand the global market acceptance of our collaborative PLM solutions, extend our global resources and help our customers quickly realize the benefits of our collaborative PLM solutions. Together with our alliance partners, we leverage our mutual strengths in the marketplace to deliver comprehensive PLM solutions. We form alliances with industry-leading software, platform and services companies for enhanced service delivery, joint sales, marketing, distribution, design and development.

### *Systems Integrators*

We have established strategic relationships with more than 50 global and regional systems integration partners that provide expertise in a number of areas including MatrixOne solution implementations, solution selection, business consulting, business process re-engineering, development of best practices and business processes, solution integration and specific industries. Our systems integration partners include Accenture, Atos Origin, Bearing Point, Capgemini, Computer Sciences Corporation, gedas, Hewlett Packard, IBM Global Services, Infosys Technologies, NS Solutions, Satyam Computer Services, Scandent, Sogeti and Tata Consulting Services.

### *Independent Software Vendors (ISVs)*

Our ISV partners, who include application developers and software solution providers, extend our collaborative PLM solutions with their suite of additional integrations and complementary applications. Our ISV partners include Inova Engineering GmbH, International TechneGroup, Inc. (ITI Transcendata), Productivity Engineering GmbH, Spicer Corporation, Telelogic AB and Verity, Inc.

### *Original Equipment Manufacturers (OEMs)*

We work with OEM partners to deliver the power of our collaboration PLM solutions as part of their own products. OEMs offer vertical solutions for a specific industry or market and add our products to their own solutions, or embed our technology into their software.

Through our alliance relationship with Cadence Design Systems, we are also providing solutions tailored specifically to the global electronics industry, a growing market segment that is beginning to involve product development activities across all major vertical markets as electronics continue to proliferate into all product categories. Our relationship with Cadence includes an OEM agreement under which Cadence embeds MatrixOne technology into design and library management environments that are marketed and supported directly by Cadence for printed circuit board ("PCB") design.

### *Platform Partners*

Our platform partners enable our customers to take advantage of technological advances and simultaneously extend the value of their investments in existing infrastructure and information systems. Our close relationship with major hardware vendors helps us develop solutions with maximum stability, security, performance and scalability. In addition, our relationships with database, middleware, operating systems and networking software companies enable our collaborative PLM solutions to run in diverse and rapidly evolving software environments and enhance the open architecture of our software, thereby enabling interoperable collaboration capabilities. Our platform partners include Hewlett-Packard, IBM, Sun Microsystems and BEA Systems.

## *Resellers*

We work with several types of resellers to deliver, implement and support our collaborative PLM solutions:

- We work with value-added resellers (“VARs”) in certain geographical regions or market segments, which in turn provide a total solution of software, implementation services and their own added-value products and services. Our customers use VARs for industry-specific solutions, particular professional services expertise, or the ability to leverage third-party systems.
- Distributors provide a sales and services channel for our customers in geographic areas where we may not have local, direct coverage. Distributors license, implement, extend and support our solutions and may also offer specific industry, application or technical know-how.
- We collaborate with other resellers, to market to and serve the needs for advanced PLM technology of small to medium sized enterprises. We have a well defined strategy to focus on certain key industrial markets – such as medical device, apparel and automotive supply – with these channel partners.

## **Competition**

The market for collaborative PLM software is intensely competitive, highly fragmented and changing rapidly. We compete against different companies depending on the geographic region, the size and industry of the potential customer and the scope of the proposed solution. We currently compete against:

- in-house development efforts by potential customers;
- vendors with CAD product backgrounds such as Dassault Systems, Parametric Technology and UGS;
- vendors with ERP product backgrounds such as Oracle and SAP;
- vendors providing some aspects of PLM functionality such as Agile Software;
- emerging companies focused on enterprise application integration and eBusiness; and
- vendors that focus on specific industrial or geographic markets.

We expect that competition will increase as a result of continued increased usage of the Internet and ongoing software industry consolidation. Moreover, a number of enterprise software companies have acquired providers of point solutions to expand their product lines and vendors with various product backgrounds continue to enter the PLM market. Our competitors may also package their products in a manner that may discourage customers from licensing our software. Current and potential competitors may establish cooperative relationships among themselves or with third-parties or may adopt aggressive pricing policies to gain market share. Consolidation in the industry also results in larger competitors that may have significantly greater combined resources than we do with which to compete against us.

We believe that our ability to compete depends on many factors, both within and beyond our control, including, without limitation:

- the performance, functionality, scalability, flexibility and business value of our solutions;
- the timing and market acceptance of new products and product enhancements;
- the effectiveness of our selling and marketing efforts; and
- the quality and performance of our services.

Although we believe that we currently compete favorably as to each of these factors, we expect competition to persist and intensify as the market in which we compete continues to mature and evolve. In addition, new competitors could emerge and rapidly capture market share. Increased competition from existing or potential competitors could result in reductions in price and revenues, reduced margins, loss of customers and loss of market share, any one of which would negatively impact our operating results.

### **Intellectual Property and Other Proprietary Rights**

Our success and ability to compete are dependent upon our ability to develop and maintain our intellectual property and proprietary technology and to operate without infringing on the proprietary rights of others. Currently, we rely on a combination of patent, copyright, trademark and trade secret laws, as well as non-disclosure agreements with our employees, customers, alliance partners, consultants and systems integrators to protect our proprietary rights. We license our software pursuant to non-exclusive license agreements that impose restrictions on our customers' ability to utilize the software. In addition, we seek to avoid disclosure of our trade secrets by executing confidentiality agreements with anyone having access to our proprietary information and restricting access to our source code. We also seek to protect our software, documentation and other written materials under trade secret and copyright laws.

We have six patents issued in the United States, one patent issued in Taiwan, four U.S. patents pending, one of which has been published, and one European Regional patent that has been published. It is possible that no patents may issue from these applications. We have twenty registered trademarks in the United States. In addition, we have thirty-six registered trademarks in various foreign jurisdictions.

Despite our efforts to protect our intellectual property and proprietary rights, existing laws afford only limited protection. We operate throughout the world and the protection available in other jurisdictions for our intellectual property may not be available to the same extent protection is available in the United States or at all. Others may be able to develop technologies that are superior or similar to our technology. Attempts may be made to reverse engineer our products or to obtain and use information that we regard as proprietary. Our customers, alliance partners, suppliers, and former employees may disclose our proprietary information to parties that may use that information to compete against us. Accordingly, we may not be able to protect our proprietary rights against unauthorized third-party copying or use. Furthermore, policing the unauthorized use of our intellectual property is difficult. Expensive litigation may be necessary in the future to enforce our intellectual property rights.

We utilize technology that is provided by third-parties and integrated into our products. These technologies may infringe another party's proprietary rights. We attempt to obtain product infringement indemnification protection in contracts when we integrate third-party products and technology into our products. It is also possible that third-parties will claim that we have infringed their proprietary rights. We expect that software providers will increasingly be subject to infringement claims as the number of products in different industry segments increase and overlap. From time to time, we have received correspondence from competitors asserting potential infringement of intellectual property rights or other claims based upon the integration of our software with one or more of their software offerings; such integrations are typically performed at the request of mutual customers.

Any resulting claim or litigation, even if successfully defended, could result in substantial costs and diversion of resources and management time and could have a material negative effect on our operating results.

## **Employees**

As of July 2, 2005, we had a total of 481 employees. Of the total employees, 124 were in product development, engineering or systems engineering, 137 in sales and marketing, 178 in services and 42 in operational, financial and administrative functions.

Our employees are not represented by a labor union and are not subject to a collective bargaining agreement. We have never experienced a work stoppage. We believe our relations with our employees are good.

## **Available Information**

Access to our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to these reports filed with or furnished to the Securities and Exchange Commission may be obtained through the Investor Relations section of our website at [www.matrixone.com/investor](http://www.matrixone.com/investor) as soon as reasonably practical after we electronically file or furnish these reports. We do not charge for access to and viewing of these reports. Information on our Investor Relations page and on our website is not part of this Annual Report on Form 10-K or any of our other securities filings unless specifically incorporated herein by reference. In addition, our filings with the Securities and Exchange Commission may be accessed through the Securities and Exchange Commission's Electronic Data Gathering, Analysis and Retrieval system at [www.sec.gov](http://www.sec.gov). All statements made in any of our securities filings, including all forward-looking statements or information, are made as of the date of the document in which the statement is included, and we do not assume or undertake any obligation to update any of those statements or documents unless we are required to do so by law.

## **ITEM 2: PROPERTIES**

Our headquarters is located in a 52,000 square foot facility in Westford, Massachusetts, which we occupy under an office lease expiring in December 2010. We also lease office space in 13 states throughout the United States, and we lease office space in Canada, England, France, Germany, Italy, Japan, Korea, Singapore and the Netherlands, under leases with terms expiring at various times through fiscal 2011. We believe that additional space will be required as our business expands and will be available on acceptable terms.

## **ITEM 3: LEGAL PROCEEDINGS**

On April 19, 2002, a consolidated amended class action complaint was filed in the United States District Court for the Southern District of New York ("Court"). The complaint, which superseded five virtually identical complaints that had been filed from July 24, 2001 to September 5, 2001, names us as a defendant along with two of our officers, and certain underwriters involved in our initial public offering of common stock ("IPO"). The complaint is allegedly brought on behalf of purchasers of our common stock during the period from February 29, 2000 to December 6, 2000 and asserts, among other things, that our IPO prospectus and registration statement violated federal securities laws because they contained material misrepresentations and/or omissions regarding the conduct of our IPO underwriters in allocating shares in our IPO to the underwriters' customers, and that we and the two named officers engaged in fraudulent practices with respect to the underwriters' conduct. The action seeks damages, fees and costs associated with the litigation, and interest. We and our officers and directors believe that the allegations in the complaint are without merit and have defended the litigation vigorously. The litigation process is inherently uncertain and unpredictable, however, and there can be no guarantee as to the ultimate outcome of this pending lawsuit. Pursuant to a stipulation between the parties, our two named officers were dismissed from the lawsuit, without prejudice, on October 9, 2002. On February 19, 2003, the Court ruled on a motion to dismiss the complaint that had been filed by us, along with the three hundred plus other publicly-traded companies that have been named by various plaintiffs in substantially similar lawsuits. The Court granted our motion to dismiss the claim filed against it under Section 10(b) of the Securities Exchange Act of 1934, but

denied our motion to dismiss the claim filed against it under Section 11 of the Securities Act of 1933, as it denied the motions under this statute for virtually every other company sued in the substantially similar lawsuits.

In June 2003, we, implementing the determination made by a special independent committee of the Board of Directors, elected to participate in a proposed settlement agreement with the plaintiffs in this litigation. If ultimately approved by the Court, this proposed settlement would result in a dismissal, with prejudice, of all claims in the litigation against us and against any of the other issuer defendants who elect to participate in the proposed settlement, together with the current or former officers and directors of participating issuers who were named as individual defendants. The proposed settlement does not provide for the resolution of any claims against the underwriter defendants, and the litigation as against those defendants is continuing. The proposed settlement provides that the class members in the class action cases brought against the participating issuer defendants will be guaranteed a recovery of \$1.0 billion by insurers of the participating issuer defendants. If recoveries totaling \$1.0 billion or more are obtained by the class members from the underwriter defendants, however, the monetary obligations to the class members under the proposed settlement will be satisfied. In addition, we and any other participating issuer defendants will be required to assign to the class members certain claims that they may have against the underwriters of their IPOs.

The proposed settlement contemplates that any amounts necessary to fund the settlement or settlement-related expenses would come from participating issuers' directors and officers liability insurance policy proceeds, as opposed to funds of the participating issuer defendants themselves. A participating issuer defendant could be required to contribute to the costs of the settlement if that issuer's insurance coverage were insufficient to pay that issuer's allocable share of the settlement costs. The Company expects that its insurance proceeds will be sufficient for these purposes and that it will not otherwise be required to contribute to the proposed settlement.

Consummation of the proposed settlement is conditioned upon obtaining approval by the Court. On September 1, 2005, the Court preliminarily approved the proposed settlement, directed that notice of the terms of the proposed settlement be provided to class members, and scheduled a fairness hearing, at which objections to the proposed settlement will be heard. Thereafter, the Court will determine whether to grant final approval to the proposed settlement.

If the proposed settlement described above is not consummated, we intend to continue to defend the litigation vigorously. Moreover, if the proposed settlement is not consummated, we believe that the underwriters may have an obligation to indemnify us for the legal fees and other costs of defending this suit. While we cannot predict with certainty the outcome of these proceedings, we believe the final outcome will result in no material effect on our consolidated financial condition, results of operations or cash flows.

We may from time to time become a party to various other legal proceedings arising in the ordinary course of our business.

#### **ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matters were submitted to a vote of our security holders during the fourth quarter of the fiscal year ended July 2, 2005, through the solicitation of proxies or otherwise.



## PART II

### ITEM 5: MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Since May 26, 2005, our common stock has been quoted on the NASDAQ National Market under the symbol "MONEE." Prior to May 26, 2005, our common stock was quoted on the NASDAQ National Market under the symbol "MONE". The price range per share reflected in the table below is the high and low bid information for our common stock as reported by NASDAQ for the periods indicated.

	<u>High</u>	<u>Low</u>
<b>Fiscal year ended July 2, 2005:</b>		
First quarter .....	\$ 6.58	\$ 4.45
Second quarter .....	\$ 7.08	\$ 5.35
Third quarter .....	\$ 6.72	\$ 4.16
Fourth quarter .....	\$ 5.15	\$ 3.87
<b>Fiscal year ended July 3, 2004:</b>		
First quarter .....	\$ 6.50	\$ 4.08
Second quarter .....	\$ 6.97	\$ 4.12
Third quarter .....	\$ 8.20	\$ 5.52
Fourth quarter .....	\$ 8.73	\$ 5.94

On October 25, 2005, there were approximately 427 stockholders of record of our common stock. This number does not include stockholders for whom shares were held in a "nominee" or "street" name. On October 25, 2005, the last reported sale price per share of our common stock on the NASDAQ National Market was \$5.00.

We have never declared or paid any cash dividends on our common stock. We currently intend to retain future earnings, if any, to finance the expansion and growth of our business and do not expect to pay any cash dividends in the foreseeable future. Payment of future cash dividends, if any, will be at the discretion of our board of directors after taking into account various factors, including our financial condition, operating results, current and anticipated cash needs and plans for expansion.

On February 29, 2000, the Securities and Exchange Commission declared effective our registration statement on Form S-1 (File No. 333-92731), relating to the initial public offering of our common stock, and we did a concurrent private placement of common stock. We expect to continue to use the net proceeds from the initial public offering and the concurrent private placement for general corporate purposes, including to expand our selling and marketing and services organizations, develop new distribution channels, expand our research and development efforts, improve our operational and financial systems and for other working capital purposes. We may also use a portion of the net proceeds to acquire or invest in complementary businesses, products or technologies. We have no specific understandings, commitments or agreements with respect to any such acquisition or investment. Except as set forth below, we have not allocated any portion of the net proceeds for any specific purpose. Our actual use of the net proceeds from the initial public offering and the concurrent private placement may differ from the uses we have identified. Pending these uses, the net proceeds of the offering and the concurrent private placement will be invested in short-term, interest-bearing, investment-grade securities. Through July 2, 2005, we have used the proceeds from the initial public offering and concurrent private placement to (a) pay for the offering expenses, (b) fund approximately \$12.4 million in investments in leasehold improvements, computer hardware and software and office furniture, (c) acquire certain businesses and technology aggregating \$6.6 million of cash consideration, (d) repurchase \$1.0 million of our common stock, and (e) fund approximately \$14.5 million of working capital to fund our operations.

On August 4, 2004, we acquired Synchronicity Software, Inc. (“Synchronicity”) for approximately \$4.5 million in cash and approximately 2.3 million shares of our common stock valued at \$5.37 per share. The shares of our common stock were issued to holders of Synchronicity convertible notes and shares of certain series of Synchronicity preferred stock in reliance upon the registration exemption of Section 4(2) and Rule 506 of the Securities Act of 1933, as amended, based on information regarding those holders.

See Part III, Item 12 for information regarding securities authorized for issuance under equity compensation plans.

## ITEM 6: SELECTED FINANCIAL DATA

You should read the data set forth below in conjunction with Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations", Item 7A, "Quantitative and Qualitative Disclosures About Market Risk" and our consolidated financial statements and related notes appearing elsewhere in this Annual Report on Form 10-K. As discussed in Notes 3 and 13 of the Notes to the Consolidated Financial Statements, the financial statements for fiscal years 2004, 2003, 2002, 2001, 2000 and 1999 and for the fiscal quarters therein, along with the first two quarters of fiscal 2005, have been restated. Fiscal years 2000 and 1999 are not presented and are unaudited. The selected consolidated statement of operations data set forth below for the fiscal years ended July 2, 2005, July 3, 2004 and June 28, 2003 and the consolidated balance sheet data as of July 2, 2005 and July 3, 2004 are derived from our audited consolidated financial statements that are included elsewhere in this Annual Report on Form 10-K.

	Year Ended				
	July 2, 2005	July 3, 2004	June 28, 2003	June 29, 2002	June 30, 2001
		(As Restated)	(As Restated)	(As Restated)	(As Restated) (Unaudited)
<b>Consolidated Statements of Operations Data:</b>					
(in thousands, except per share data)					
Revenues:					
Software license.....	\$ 47,300	\$ 38,747	\$ 38,006	\$ 45,289	\$ 78,294
Service .....	76,754	70,830	67,015	73,660	61,144
Total revenues.....	124,054	109,577	105,021	118,949	139,438
Cost of revenues:					
Software license.....	4,287	3,223	3,363	3,557	7,996
Amortization of purchased technology.....	731	—	—	—	—
Service .....	49,472	46,218	46,467	54,118	45,339
Total cost of revenues.....	54,490	49,441	49,830	57,675	53,335
Gross profit.....	69,564	60,136	55,191	61,274	86,103
Operating expenses:					
Selling and marketing.....	44,638	36,621	41,530	48,154	55,446
Research and development .....	29,080	23,028	26,377	31,218	20,149
General and administrative .....	16,030	10,256	10,485	11,503	10,399
Amortization of intangible assets .....	414	—	—	—	—
Stock-based compensation.....	—	567	3,195	3,910	4,142
Restructuring charges .....	—	1,751	3,423	2,812	—
Asset impairment and disposal charges .....	—	1,680	—	—	—
Total operating expenses .....	90,162	73,903	85,010	97,597	90,136
Income (loss) from operations .....	(20,598)	(13,767)	(29,819)	(36,323)	(4,033)
Other income (expense), net.....	1,780	1,393	1,908	3,399	8,940
Provision for income taxes .....	1,503	32	291	100	1,465
Income (loss) from continuing operations .....	(20,321)	(12,406)	(28,202)	(33,024)	3,442
Income from discontinued operations.....	—	—	—	—	1,025
Net income (loss).....	\$ (20,321)	\$ (12,406)	\$ (28,202)	\$ (33,024)	\$ 4,467
<b>Basic net income (loss) per share:</b>					
Continuing operations.....	\$ (0.40)	\$ (0.26)	\$ (0.59)	\$ (0.72)	\$ 0.08
Discontinued operations .....	—	—	—	—	0.02
Net income (loss).....	\$ (0.40)	\$ (0.26)	\$ (0.59)	\$ (0.72)	\$ 0.10
Shares used in computation .....	51,238	48,411	47,489	46,147	43,543
<b>Diluted net income (loss) per share:</b>					
Continuing operations.....	\$ (0.40)	\$ (0.26)	\$ (0.59)	\$ (0.72)	\$ 0.07
Discontinued operations .....	—	—	—	—	0.02
Net income (loss).....	\$ (0.40)	\$ (0.26)	\$ (0.59)	\$ (0.72)	\$ 0.09
Shares used in computation .....	51,238	48,411	47,489	46,147	50,357

			As of		
	July 2, 2005	July 3, 2004	June 28, 2003	June 29, 2002	June 30, 2001
		(As Restated)	(As Restated)	(As Restated)	(As Restated) (Unaudited)
<b>Consolidated Balance Sheet Data:</b>			(in thousands)		
Cash and cash equivalents .....	\$ 107,677	\$ 118,414	\$ 127,665	\$ 139,642	\$ 156,349
Working capital .....	\$ 79,104	\$ 100,535	\$ 104,517	\$ 123,480	\$ 150,601
Total assets .....	\$ 172,960	\$ 159,378	\$ 168,078	\$ 198,858	\$ 218,070
Total stockholders' equity .....	\$ 101,782	\$ 107,946	\$ 117,648	\$ 140,953	\$ 165,724

## ITEM 7: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*You should read the following discussion and analysis together with our consolidated financial statements and related notes and other financial information appearing elsewhere in this Annual Report on Form 10-K.*

The following discussion and analysis gives effect to the restatement described in Note 3 of the Notes to the Consolidated Financial Statements. For this reason, the data set forth in this section may not be comparable to discussions and data in our previously filed annual and quarterly reports.

### Business Overview

MatrixOne, Inc. is a provider of collaborative product lifecycle management ("PLM") solutions. Our solutions enable companies from a broad range of industries to accelerate innovation and time to market and drive efficiencies into the product development processes by allowing for the collaborative development, building and management of their products. Our solutions bring together people, processes, content and systems throughout global value chains of employees, customers, suppliers and partners to achieve a competitive advantage by bringing the right products and services to market cost-effectively. By unifying and streamlining processes across the product lifecycle, companies can easily work on projects with parties inside and outside of their enterprises to achieve greater efficiency and profitability. In addition, our technology enables companies to adapt, react and scale quickly to address their ever-changing business requirements.

On August 4, 2004, we acquired Synchronicity Software, Inc. ("Synchronicity"), a provider of electronic design management, team collaboration and intellectual property reuse solutions for the global electronics industry. Synchronicity offers the Synchronicity Developer Suite, a solution for managing large-scale semiconductor designs that supports the Electronic Design Automation ("EDA") industry's leading databases – OpenAccess and Milkyway™. Synchronicity also offers the Synchronicity Publisher and Consumer Suites, a solution for IP management, distribution and reuse. Synchronicity has approximately 120 electronics industry customers, including 13 of the largest 15 semiconductor companies. The combination of Synchronicity and MatrixOne provides solutions for companies that have high-value electronic content in their products. The acquisition of Synchronicity has added new solutions for semiconductor and electronics design management to the solutions portfolio of MatrixOne, expanded our customer base and deepened our domain expertise in the electronics industry. Our customers, who come from many industries including automotive, aerospace, consumer, machinery, medical device and high technology, are being confronted with new design, manufacturing and quality challenges as the electronics content in their products increase and new product development cycle times compress. To deal with these challenges, our customers look to us to provide an integrated development environment that will enable them to effectively manage not only the mechanical design aspect of their products but also the electronics and software components. The combined solution of MatrixOne and Synchronicity allows MatrixOne to address a new and rapidly emerging market for PLM by directly connecting the electronic design environment to the extended enterprise. Together, MatrixOne and Synchronicity solutions are designed to enable global design teams to work together with their development partners, customers and suppliers to reduce design and development costs, leverage design expertise, improve quality and accelerate time to market.

On November 12, 2004, we acquired certain intangible assets of Centor Software Corporation ("Centor"), a provider of software for documenting and validating regulatory compliance with the European Union directives that target banned substances and recycling for the automotive and electronics industries (the "Centor acquisition"). The Centor acquisition added new solutions for regulatory compliance to the solutions portfolio of MatrixOne and expanded our customer base by the addition of approximately 20 new customers. Many of our customers are facing new design and manufacturing challenges as the content in their products increasingly becomes subject to regulations aimed at reducing the amount of hazardous materials in new products and ensuring that materials are recyclable at the end of their product lifecycle. Our customers need an integrated development environment that will enable them to effectively manage the compliance process at the earliest stages of design. The combined solution of MatrixOne and Centor is expected to allow MatrixOne to address this new and rapidly



emerging market for PLM by providing a complete out of the box solution for reporting, analyzing, and iterating on product data, along with aggregation of supplier data. Together, MatrixOne and Centor solutions will be designed to allow material and substance data and specifications to be incorporated in product development decisions throughout the product lifecycle.

Our collaborative PLM solutions are based on our suite of software products, collectively referred to as Matrix10. Our Matrix10 offering is a comprehensive and flexible PLM environment that consists of four components: the Matrix PLM Platform, our Business Process Applications, our Enterprise Integration offerings, and our MatrixOne Accelerators. We offer a variety of services that complement our PLM solutions. Our professional services personnel provide rapid and cost-effective implementation, integration and other consulting services. These personnel capture and model the specific business processes that reflect our customers' planning, design, manufacturing, sales and service practices. We also provide training and maintenance and customer support services to enhance the value of our products to our customers. In addition, we have a global network of systems integrators who are experienced in providing implementation and integration services to our customers. Many of our customers use their preferred systems integrators and others perform their own implementation.

Our long-term strategy is to achieve sustainable growth in revenue and net income by achieving a leadership position within the PLM market by effectively enabling our customers to achieve measurable improvements in their business by unifying and streamlining processes across the product lifecycle. Currently, there are three key elements to our growth strategy: driving new customer adoption of our solutions in collaboration with our key alliance partners, upgrading our growing base of existing customers to the latest releases of our solutions, and extending our position in key industrial markets.

The first element of our strategy is focused on driving adoption of our collaborative PLM solutions by new customers. We believe that revenue from new customers is the industry's best indicator of competitive market strength today and market share growth in the future. Many companies which deploy PLM solutions tend to start with a specific business problem, and after successfully solving that business problem, develop the confidence and funding to address adjacent business problems – thereby creating additional selling opportunities for us. To target and serve these potential new customers, we work collaboratively with our key alliance partners.

The second element of our strategy is predicated on upgrading our growing base of existing customers to the latest releases of our solutions. The latest major release, Matrix10, includes significant enhancements in security, scalability, and interoperability compared to previous releases of our product offerings. Because many of our existing customers operate with previous releases of our products, we believe that there are opportunities to grow software license and professional services revenue by effectively upgrading our installed base of customers to Matrix10, which may result in the licensing of additional software products and the commencement of additional professional services engagements both during and after the upgrade.

The third element of our strategy is focused on extending our position in key industrial markets. We license our PLM solutions primarily in eight industrial markets: aerospace and defense, automotive, consumer products, financial services, machinery, high technology, medical devices, and the process industries. To gain market leadership in each of these industrial markets, a core part of our growth strategy is to: leverage our strong horizontal PLM capabilities; develop and market focused variations of our core product offerings to meet the needs of industry-specific business processes; develop the deep domain expertise of our workforce in the industrial markets in which we compete; and develop and leverage alliance partnerships with key system integration partners, original equipment manufacturers, and complementary hardware and software providers.

## Financial Overview

We generate revenues from licensing our software and providing professional services, training and maintenance and customer support services through our offices in the United States, Canada, England, France, Germany, Italy, Japan, Korea, Singapore and the Netherlands and indirectly through our Alliance Partner network throughout Europe and Asia/Pacific. Revenues by geographic region fluctuate each period based on the timing, size and number of software license and professional services transactions and fluctuation in the value of foreign currencies relative to the U.S. Dollar. We expect our revenues by geographic region to continue to fluctuate in the future. Our total revenues by major geographic region, including exports into such regions, for fiscal 2005, 2004 and 2003 were as follows:

(In thousands)	Year Ended		
	July 2, 2005	July 3, 2004 (As Restated)	June 28, 2003 (As Restated)
North America .....	\$ 68,764	\$ 57,200	\$ 60,600
Europe .....	41,454	38,361	28,967
Asia/Pacific .....	13,836	14,016	15,454
	<u>\$ 124,054</u>	<u>\$ 109,577</u>	<u>\$ 105,021</u>

Our international subsidiaries generally invoice their customers and pay their employees and suppliers in local currency. Therefore, our revenues and expenses from these international subsidiaries, when translated to U.S. Dollars, are subject to foreign currency risk. We currently do not enter into contracts or agreements to minimize our exposure to the effects of changes in foreign currency when the results of our international subsidiaries are translated to U.S. Dollars. Accordingly, if the dollar weakens relative to foreign currencies, our revenues and expenses would increase when stated in U.S. Dollars. Conversely, if the dollar strengthens, our revenues and expenses would decrease. If the revenues from our international subsidiaries for the twelve months ended July 2, 2005 had been translated at exchange rates for the comparable period a year ago, our total revenues would have been approximately \$2.5 million lower.

We have incurred significant costs to develop our technology and products, market, license, sell, implement and support our products and services, and maintain an infrastructure to support our global operations. These costs have historically exceeded our total revenues. As of July 2, 2005, we had an accumulated deficit of approximately \$128.1 million. If our operating expenses are higher than we anticipate or our revenues are lower than anticipated, we may incur significant net losses in fiscal 2006 and beyond.

### *Critical Accounting Policies and Estimates*

This discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”). The preparation of these financial statements requires us to make estimates and judgments, which we evaluate on an on-going basis, that affect the reported amounts of assets, liabilities, revenues and expenses. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates and judgments under different assumptions or conditions.

We believe the following sets forth the most important accounting policies we used in the preparation of our consolidated financial statements and those that affect our more significant estimates and judgments, which have been reviewed by our Disclosure Committee, consisting primarily of our senior management team, and the Audit Committee of our Board of Directors.

## Revenue Recognition

We generate revenues from licensing our software and providing professional services, training and maintenance and customer support services. We execute separate contracts that govern the terms and conditions of each software license and maintenance arrangement and each professional services arrangement. These contracts may be considered together as a single multiple-element arrangement. Revenues under multiple-element arrangements, which may include several different software products or services sold together, are allocated to each element using the residual method.

We use the residual method when fair value does not exist for one of the delivered elements in an arrangement. Under the residual method, the fair value of the undelivered elements is deferred and subsequently recognized. We have established sufficient vendor specific objective evidence of fair value for professional services, training and maintenance and customer support services, except for maintenance and customer support services in Japan, based on the price charged when these elements are sold separately. Accordingly, software license revenue is recognized under the residual method in arrangements in which software is licensed with professional services, training or maintenance and customer support services.

We have not established sufficient vendor specific objective evidence of fair value for maintenance and customer support services in Japan. Accordingly, the software license fees in Japan are recognized ratably over the term of the related maintenance and customer support services contract, generally one year, on a straight-line basis.

We primarily provide the following four types of software license arrangements:

- *Perpetual software license* - we recognize software license revenues from perpetual licenses under the residual method upon execution of a signed software license agreement, delivery of the software to a customer and determination that collection of a fixed or determinable license fee is probable;
- *Two year or more time-based license* - we recognize software license revenues from two year or more time-based licenses under the residual method upon execution of a signed software license agreement, delivery of the software to a customer and determination that collection of a fixed or determinable license fee is probable;
- *Less than two year time-based license* - we recognize software license revenues from less than two year time-based licenses ratably over the period of the license arrangement. Since we do not have vendor specific objective evidence of fair value for maintenance and customer support for such arrangements, both the software license and maintenance and customer support fees are included in software license revenues; and
- *Revenue sharing, royalty and subscriber arrangements with and through third-parties* – we recognize revenue sharing, royalty and subscriber arrangements with and through third-parties as software license revenue when they are fixed and determinable, generally upon receipt of a statement from the third-party and determination that collection of the fixed or determinable license fee is probable.

If a customer is provided extended payment terms, revenue is recognized when the fees become due. A software license is considered delivered when the customer receives the physical media in accordance with the applicable shipping terms or is provided access to the electronic software files.

In accordance with our agreements with our value-added resellers and distributors (“Alliance Partners”), an Alliance Partner has the right to license our software to its customers (“end users”). Therefore, we have no obligation to the Alliance Partner’s end users. Accordingly, we recognize software license revenues from an Alliance Partner upon receipt of a written confirmation from the Alliance Partner of an arrangement with the

ultimate end user, delivery of the software to the Alliance Partner and when all other revenue recognition criteria, including fulfillment of all obligations and commitments, are met.

Service revenues include professional services, reimbursements received for out-of-pocket expenses incurred, training and maintenance and customer support fees. Professional services generally are not essential to the functionality of the other elements in an arrangement and are accounted for separately. Professional services revenues are primarily derived from time and material contracts and are recognized as the services are performed. Professional services revenues for fixed-price contracts are recognized using a concept of proportional performance based upon the ratio of direct labor costs incurred to total expected labor costs. If conditions for acceptance are required or the arrangement includes future product deliverables, professional services revenues and related software license revenues are recognized upon customer acceptance or upon delivery of the future deliverables. Our customers generally reimburse us for the majority of our out-of-pocket expenses incurred during the course of an engagement. We do not mark-up or add additional fees to the actual out-of-pocket expenses we incur. Training revenues are recognized as the services are provided.

For arrangements that include the licensing of software and the performance of professional services under a fixed-price contract, both the software license revenues and professional services revenues are recognized using a concept of proportional performance based upon the ratio of direct labor costs incurred to total expected labor costs.

Maintenance and customer support fees include the right to unspecified upgrades on a when-and-if-available basis and ongoing technical support. Maintenance and customer support fees are recognized ratably over the term of the contract, generally one year, on a straight-line basis. When a maintenance and customer support fee is included in a software license fee, we allocate a portion of the software license fee to maintenance and customer support fees based on the renewal rate of maintenance and customer support fees.

#### *Allowance for Doubtful Accounts*

We periodically assess the collectibility of customer accounts receivable. We maintain an allowance for estimated losses resulting from uncollectible customer accounts receivable. In estimating this allowance, we consider customer specific factors such as historical collection experience, current credit worthiness, the aggregate amount due, age of the receivable and general economic conditions that may affect a customer's ability to pay. We also consider factors such as the overall balance and aging of our accounts receivable, as well as customer and geographic concentrations. Actual customer collections could differ materially from our estimates. The use of different estimates or assumptions could produce a materially different allowance. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. Our allowance for doubtful accounts was \$0.7 million at July 2, 2005 and \$0.9 million at July 3, 2004.

#### *Property and Equipment*

We estimate the useful lives of our property and equipment, and we record depreciation on a straight-line basis over the estimated useful lives of our property and equipment. We regularly review our estimate of the useful lives and net book value of our property and equipment in order to determine if events and circumstances, such as changes in technology, product obsolescence and changes in our business, may require a change in the estimated useful lives of our property and equipment or recognition of an impairment loss, both of which would increase our operating expenses.

As a result of our restructuring program in October 2003, we evaluated the recoverability of certain of our assets. Based on this evaluation, we determined that certain assets would not be recoverable, and we recorded asset impairment and disposal charges of \$1.7 million in fiscal 2004. For additional information regarding this impairment charge, refer to Note 1 to our Consolidated Financial Statements included in Part II, Item 8 in this Annual Report on Form 10-K.

#### *Accounting for Business Combinations*

We are required to allocate the purchase price of business combinations to the tangible and intangible assets acquired and liabilities assumed based on their estimated fair values. Such a valuation, which is determined with the assistance of an independent valuation firm, requires us to make significant estimates and assumptions, especially with respect to intangible assets.

Critical estimates in valuing certain of the intangible assets include but are not limited to:

- future expected cash flows from software license sales, maintenance and customer support agreements, consulting contracts, customer contracts and related customer relationships and acquired developed technologies and trademarks and trade names;
- expected costs to develop the in-process research and development into commercially viable products and estimating cash flows from the projects when completed;
- the acquired company's brand awareness and market position, as well as assumptions about the period of time the acquired brand will continue to be used by the combined company; and
- discount rates.

Our estimates of fair value are based upon assumptions believed to be reasonable at that time, but which are inherently uncertain and unpredictable. Assumptions may be incomplete or inaccurate, and unanticipated events and circumstances may occur. In addition, we estimate the useful lives of our intangible assets based upon the expected period over which we anticipate generating economic benefits from the related intangible asset.

#### *Goodwill Impairment*

Goodwill is required to be tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis and between annual tests in certain circumstances. We evaluate the impairment of goodwill annually in our fourth fiscal quarter with the assistance of an independent valuation firm. Application of the goodwill impairment test requires making judgments about the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value of the reporting units. We have determined that we have one reporting segment (see Note 12 of our Consolidated Financial Statements included in Part II, Item 8 in this Annual Report on Form 10-K) and one reporting unit. Significant judgments required to estimate the fair value of a reporting unit include estimating future cash flows and determining appropriate discount rates. Changes in these judgments, estimates and assumptions could materially affect the determination of fair value for the reporting unit and therefore the determination as to the existence or size of any impairment. Any impairment losses recorded in the future could have a material adverse impact on our financial condition and results of operations.

#### *Impairment of Long-Lived Assets*

We are required to record an impairment charge on long-lived tangible and finite-lived intangible assets when we determine that the carrying value of these assets may not be recoverable. As a result of the existence of one or more indicators of impairment, we measure any impairment of long-lived assets based on a projected discounted cash flow method using a discount rate determined by us to be commensurate with the risk inherent in our

business model. Our estimates of cash flows require significant judgment based on our historical results and anticipated results and are subject to many factors. Significant management judgment is required in: identifying a triggering event that arises from a change in circumstances; forecasting future operating results; and estimating the proceeds from the disposition of long-lived assets. Changes or inaccuracies in our judgments, estimates and assumptions could materially impact our determination of the existence or size of any impairment. We may be required to record material impairment charges should different conditions prevail or different judgments be made.

#### *Deferred Tax Assets*

Under applicable accounting criteria, we record a valuation allowance to reduce our deferred tax assets to the estimated amount that is more likely than not to be realized. During our assessment of the valuation allowance, we consider future taxable income and ongoing tax planning strategies on a consolidated basis and in the tax jurisdictions in which we operate. We have recorded a valuation allowance against our deferred tax assets due to the fact it is more likely than not that the deferred tax assets will not be realized. We regularly evaluate the realizability of our deferred tax assets and may adjust the valuation allowance based on such analysis. For additional information regarding our deferred tax assets and the related valuation allowance, refer to Note 8 to our Consolidated Financial Statements included in Part II, Item 8 in this Annual Report on Form 10-K.

#### *Professional Services Warranty*

Our professional services are generally warranted to be performed in a workmanlike manner. In the event the customer requests the work be corrected, we generally will provide these additional professional services at no charge to comply with our warranty obligations and to ensure customer satisfaction.

We estimate our professional services warranty liability based on historical activity. Warranty expense is included in cost of services. If our actual warranty activities differ from these estimates, revisions to the estimated warranty liability would be required and result in additional charges to cost of services. We primarily satisfy our warranty obligations by providing in-kind services. Our warranty accrual was \$0.3 million at both July 2, 2005 and July 3, 2004. For additional information regarding the activity related to our warranty accrual, refer to Note 7 to our Consolidated Financial Statements included in Part II, Item 8 in this Annual Report on Form 10-K.

## Results of Operations

The following table sets forth certain statements of operations data as a percentage of total revenues for the periods indicated. These historical results are not necessarily indicative of results to be expected for any future period.

	Year Ended		
	July 2, 2005	July 3, 2004	June 28, 2003
		(As Restated)	(As Restated)
Revenues:			
Software license .....	38.1%	35.4%	36.2%
Service .....	61.9	64.6	63.8
Total revenues .....	100.0	100.0	100.0
Cost of revenues:			
Software license .....	3.4	2.9	3.2
Amortization of purchased technology .....	0.6	—	—
Service .....	39.9	42.2	44.2
Total cost of revenues .....	43.9	45.1	47.4
Gross profit .....	56.1	54.9	52.6
Operating expenses:			
Selling and marketing .....	36.0	33.4	39.5
Research and development .....	23.5	21.0	25.1
General and administrative .....	12.9	9.4	10.0
Amortization of intangibles .....	0.3	—	—
Stock-based compensation .....	—	0.5	3.0
Restructuring charges .....	—	1.6	3.3
Asset impairment and disposal charges .....	—	1.5	—
Total operating expenses .....	72.7	67.4	80.9
Loss from operations .....	(16.6)	(12.5)	(28.3)
Other income, net .....	1.4	1.2	1.7
Provision for income taxes .....	1.2	0.0	0.3
Net loss .....	(16.4)%	(11.3)%	(26.9)%

## Comparison of the Fiscal Years Ended July 2, 2005 and July 3, 2004

**Software license revenues.** We derive our software license revenues principally from licensing our collaborative PLM solutions including our Matrix PLM Platform, Business Process Applications and Enterprise Integrations.

Software license revenues from our suite of software products, the number of software license transactions and the number of software license transactions in excess of \$1.0 million for fiscal 2005 and fiscal 2004 were as follows:

(In thousands, except transaction volumes)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 2, 2005	July 3, 2004 (As Restated)		
Matrix PLM Platform .....	\$ 14,943	\$ 18,454	\$ (3,511)	(19.0)%
Business Process Applications.....	23,149	16,263	6,886	42.3%
Enterprise Integrations .....	9,208	4,030	5,178	128.5%
Total software license revenues .....	<u>\$ 47,300</u>	<u>\$ 38,747</u>	<u>8,553</u>	22.1%
Number of software license transactions recognized <sup>(1)</sup> .....	320	218	102	46.8%
Number of software license transactions in excess of \$1.0 million recognized <sup>(1)</sup> .....	8	4	4	100.0%

<sup>(1)</sup>Excludes transactions recognized on a ratable basis.

Software license revenues by geographic region fluctuate each period based on the timing, size and number of software license transactions. We report software license revenues in the geographic region of the customer placing the software license order. However, the customer may deploy software licenses in other geographic regions. Software license revenues by geographic region for fiscal 2005 and fiscal 2004 were as follows:

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 2, 2005	July 3, 2004 (As Restated)		
North America .....	\$ 24,559	\$ 17,567	\$ 6,992	39.8%
Europe .....	15,667	13,675	1,992	14.6%
Asia/Pacific .....	7,074	7,505	(431)	(5.7)%
Total software license revenues .....	<u>\$ 47,300</u>	<u>\$ 38,747</u>	<u>\$ 8,553</u>	22.1%

Software license revenues increased primarily due to an improvement in sales force productivity and incremental software license revenue related to the acquisitions of Synchronicity and Centor. As a result of these factors, the number of software license transactions, software license transactions with new customers and software license transactions in excess of \$1.0 million have increased.

Software license revenues from our Matrix PLM Platform decreased in fiscal 2005 due to a lower average dollar amount per transaction as compared to fiscal 2004. Software license revenues from our Business Process Applications increased during fiscal 2005 primarily due to incremental software license revenue related to the addition of the Synchronicity and Centor suites of products. Software license revenues from our Enterprise Integration Products increased as a result of an increase in the number of software license transactions that included our Enterprise Integration Products and the introduction of several new integration products.



Software license revenues in Asia/Pacific decreased in fiscal 2005 due to both a reduction in the number of software license transactions in excess of \$1.0 million and the number of software license transactions. However, during fiscal 2005, the number of software license transactions with new customers in Asia Pacific increased. During fiscal 2005, software license revenues in Europe increased primarily as a result of two software license transactions in excess of \$1.0 million, an increase in the number of transactions with both new and existing customers and incremental software license revenue related to the acquisition of Synchronicity. Software license revenues in North America increased primarily as a result of two additional license transactions in excess of \$1.0 million, incremental software license revenue related to the acquisitions of Synchronicity and Centor and an increase in the number of license software transactions with both new and existing customers.

**Service revenues.** We provide services to our customers and systems integrators consisting of professional services, training and maintenance and customer support services. Our service revenues also include reimbursements received for out-of-pocket expenses incurred. Our professional services, which include implementation and consulting services, are primarily provided on a time and materials basis. Typically, our customers reimburse us for the majority of our out-of-pocket expenses incurred during the course of an engagement. We do not mark-up or add additional fees to the actual out-of-pocket expenses we incur. We also offer training services to our customers, distributors and systems integrators either in our offices throughout the world or at customer locations. Customers that license our products generally purchase annually renewable maintenance contracts, which provide customers with the right to receive unspecified software upgrades and technical support over the term of the contract. The components of our services revenues for fiscal 2005 and fiscal 2004 were as follows:

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 2, 2005	July 3, 2004 (As Restated)		
Maintenance revenues .....	\$ 40,371	\$ 34,469	\$ 5,902	17.1%
Professional services revenues .....	33,619	34,398	(779)	(2.3)%
Training revenues .....	<u>2,764</u>	<u>1,963</u>	<u>801</u>	40.8%
Total service revenues .....	<u>\$ 76,754</u>	<u>\$ 70,830</u>	<u>\$ 5,924</u>	8.4%
Maintenance as a percentage of service revenues .....	52.6%	48.7%	3.9%	

Service revenues increased primarily as a result of incremental maintenance revenues related to the acquisition of Synchronicity and continued expansion of our maintenance base as a result of the growth in our software license revenue. Professional services revenues decreased due to the deferral of professional services revenue related to certain customer arrangements that included certain commitments to provide further software functionality. Training revenues can fluctuate from period to period based on the timing of new and existing customers attending training classes and customer purchases of web-based training products. The increase in training revenue during fiscal 2005 reflects the growth in the number of new customers.

**Cost of software licenses.** Cost of software licenses primarily consists of royalties paid to third-parties for certain Business Process Applications and Enterprise Integration products licensed to our customers. Cost of software licenses also includes the cost of manuals and product documentation, production media used to deliver our products and shipping costs. Our cost of software licenses fluctuates from period to period due to changes in the mix of software licensed to third-parties for our Business Process Applications and Enterprise Integration offerings.

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 2, 2005	July 3, 2004 (As Restated)		
Cost of software licenses .....	\$ 4,287	\$ 3,223	\$ 1,064	33.0%
Amortization of purchased technology .....	731	—	731	100.0%
Total cost of software licenses .....	<u>\$ 5,018</u>	<u>\$ 3,223</u>	<u>\$ 1,795</u>	55.7%

Cost of software licenses increased due to a \$1.3 million increase in royalties resulting from increased product revenues of our Enterprise Integration offerings, which was slightly offset by a \$0.3 million decrease in royalties due to a favorable mix of Business Process Applications with no related third party royalties. Amortization of purchased technology relates to the identified intangible assets purchased in the Synchronicity acquisition, which are amortized on a straight-line basis over their estimated useful lives of three to seven years.

**Cost of services.** Cost of services includes salaries and related expenses for internal services personnel and costs of contracting with independent systems integrators to provide consulting services. Cost of services fluctuates based on the mix of internal professional services personnel and more expensive independent systems integrators used for professional services engagements. Our gross margins may fluctuate based on the actual costs incurred to provide professional services.

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 2, 2005	July 3, 2004 (As Restated)		
Cost of services .....	\$ 49,472	\$ 46,218	\$ 3,254	7.0%

Cost of services increased primarily due to a \$2.5 million increase in personnel costs as a result of an expansion of our professional services organization, our acquisition of Synchronicity and a \$1.2 million increase in offshore, domestic and international contractor expense to support the growth in our global implementations. The increases in personnel and contractor expenses were slightly offset by reductions in depreciation and other general operating expenses.

**Gross profit.** The following sets forth certain information regarding the gross profit and gross margin on our software license and service revenues:

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 2, 2005	July 3, 2004 (As Restated)		
Gross profit on software license revenues .....	\$ 42,282	\$ 35,524	\$ 6,758	19.0%
Gross profit on service revenues .....	<u>27,282</u>	<u>24,612</u>	<u>2,670</u>	10.8%
Total gross profit .....	<u>\$ 69,564</u>	<u>\$ 60,136</u>	<u>\$ 9,428</u>	15.7%
Gross margin on software license revenues .....	89.4%	91.7%	(2.3)%	
Gross margin on service revenues .....	35.5%	34.7%	0.8%	
Total gross margin .....	56.1%	54.9%	1.2%	
Percentage of total revenues derived from software license revenues .....	38.1%	35.4%	2.7%	
Percentage of total revenues derived from service revenues .....	61.9%	64.6%	(2.7)%	

Total gross profit and gross margin increased primarily due to an increase in software license revenues, the increase in the proportion of total revenues derived from software license revenues and an improvement in gross margin on service revenues. Gross margin on software license revenues decreased due to the incremental software revenues and related royalties from our Enterprise Integration offerings. Gross profit and gross margin on service revenues increased primarily due to the growth in higher margin maintenance revenues as well as the growth in training revenues.

**Selling and marketing.** Selling and marketing expenses include marketing costs, such as public relations and advertising, trade shows, marketing materials and customer user group meetings, and selling costs such as sales training events and commissions. Selling and marketing costs may fluctuate based on the timing of trade shows and user group events and the amount of sales commissions, which vary based upon revenues.

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 2, 2005	July 3, 2004 (As Restated)		
Selling and marketing expenses .....	\$ 44,638	\$ 36,621	\$ 8,017	21.9%
Selling and marketing expenses as a percentage of total revenues .....	36.0%	33.4%	2.6%	

Selling and marketing expenses increased primarily due to a \$5.0 million increase in personnel and travel related costs as a result of our acquisition of Synchronicity and the growth in the size of our sales organization. Marketing events and public relations increased \$0.5 million. In addition, commission expense increased \$2.5 million due to the increase in software license revenues.

**Research and development.** Research and development expenses include costs incurred to develop our intellectual property and are charged to expense as incurred. To date, software development costs have been charged to expense as incurred because the costs incurred from the attainment of technological feasibility to general product release have not been significant. Research and development costs may fluctuate based on the use of third-parties to assist in the development of our software products.

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 2, 2005	July 3, 2004 (As Restated)		
Research and development expenses .....	\$ 29,080	\$ 23,028	\$ 6,052	26.3%
Research and development expenses as a percentage of total revenues.....	23.5%	21.0%	2.4%	

Research and development expenses increased during fiscal 2005 primarily due to a \$4.1 million and \$2.0 million increase in personnel costs and contractor costs, respectively, as a result of our acquisitions of Synchronicity and Centor.

**General and administrative.** General and administrative expenses consist primarily of compensation of executive, finance, investor relations, human resource and administrative personnel, legal and accounting services and provisions for doubtful accounts.

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 2, 2005	July 3, 2004 (As Restated)		
General and administrative expenses .....	\$ 16,030	\$ 10,256	\$ 5,774	56.3%
General and administrative expenses as a percentage of total revenues.....	12.9%	9.4%	3.5%	

General and administrative expenses in fiscal 2005 includes \$4.6 million in audit, legal and forensic accounting expenses related to the investigation of our revenue recognition practices and the restatement of our financial statements, and \$0.9 million related to the testing of our internal controls over financial reporting and increased audit fees. General and administrative expenses also increased during fiscal 2005 as a result of a charge of approximately \$0.4 million related to a separation arrangement with our former Chief Financial Officer and additional temporary help and contractor costs.

**Amortization of intangible assets.** Amortization of intangible assets consists of the amortization of the identified intangible assets related to customer contracts and related customer relationships and trademarks and trade names acquired in the Synchronicity and Centor acquisitions, which are amortized on a straight-line basis over the estimated useful lives of the assets of four to ten years.

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 2, 2005	July 3, 2004		
Amortization of intangible assets.....	\$ 414	—	\$ 414	100.0%
Amortization of intangible assets as a percentage of total revenues.....	0.3%	—	0.3%	

**Stock-based compensation.** Stock-based compensation relates to the issuance of stock options to employees with exercise prices below the deemed fair value of our common stock on the date of grant. In connection with certain stock option grants during fiscal 2000 and fiscal 1999, we recorded deferred stock-based compensation totaling approximately \$17.7 million. Deferred stock-based compensation represents the difference between the option exercise price and the deemed fair value of our common stock on the date of the option grant. Deferred stock-based compensation, a component of stockholders' equity, is amortized through charges to operations ratably over the vesting period of the options, which is generally four years.

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 2, 2005	July 3, 2004		
Stock-based compensation expenses .....	—	\$ 567	\$ (567)	(100.0)%
Stock-based compensation expenses as a percentage of total revenues.....	—	0.5%	(0.5)%	

The deferred stock-based compensation was completely amortized as of the three month period ended January 3, 2004 when the options outstanding became fully vested.

**Restructuring charges.** As discussed in the comparison of the fiscal years ended July 3, 2004 and June 28, 2003, in October 2003, April 2003, and October 2002, we implemented restructuring programs to reduce our expenses. Substantially all such expenses were paid by July 2, 2005.

**Asset impairment and disposal charges.** As discussed in the comparison of the fiscal years ended July 3, 2004 and June 28, 2003, in conjunction with the October 2003 restructuring program, we recorded an asset impairment charge of \$1.2 million and an asset abandonment and disposal charge of \$0.5 million in fiscal 2004.

**Other income (expense).** Other income (expense) fluctuates based on interest income earned on our investments and the amount of cash available for investment, realized and unrealized gains and losses on foreign currency transactions and gains and losses on sales and disposals of fixed assets.

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 2, 2005	July 3, 2004		
Other income (expense), net .....	\$ 1,780	\$ 1,393	\$ 387	27.8%

Other income increased primarily due to increased interest income from higher yields on our investments.

**Provision for income taxes.** During fiscal 2005, we recorded a provision for income taxes of \$1.5 million consisting of an estimated foreign tax audit settlement of \$0.6 million, a deferred tax liability of \$0.3 million related to amortization of goodwill for tax purposes related to our acquisitions and current U.S. federal, state and foreign taxes. During fiscal 2004 we recorded a provision for income taxes of less than \$0.1 million, primarily consisting of current U.S. federal, state and foreign taxes.

## Comparison of the Fiscal Years Ended July 3, 2004 and June 28, 2003

**Software license revenues.** Software license revenues from our suite of software products, the number of software license transactions and the number of software license transactions in excess of \$1.0 million for fiscal 2004 and fiscal 2003 were as follows:

(In thousands, except transaction volumes)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 3, 2004 (As Restated)	June 28, 2003 (As Restated)		
Matrix PLM Platform .....	\$ 18,454	\$ 16,397	\$ 2,057	12.5%
Business Process Applications.....	16,263	17,519	(1,256)	(7.2)%
Enterprise Integrations.....	4,030	4,090	(60)	(1.5)%
Total software license revenues .....	<u>\$ 38,747</u>	<u>\$ 38,006</u>	<u>\$ 741</u>	1.9%
Number of software license transactions recognized <sup>(1)</sup> .....	218	180	38	21.1%
Number of software license transactions in excess of \$1.0 million recognized <sup>(1)</sup> .....	4	7	(3)	(42.9)%

<sup>(1)</sup>Excludes transactions recognized on a ratable basis.

Software license revenues by geographic region for fiscal 2004 and fiscal 2003 were as follows:

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 3, 2004 (As Restated)	June 28, 2003 (As Restated)		
North America .....	\$ 17,567	\$ 20,421	\$ (2,854)	(14.0)%
Europe .....	13,675	8,632	5,043	58.4%
Asia/Pacific.....	7,505	8,953	(1,448)	(16.2)%
Total software license revenues.....	<u>\$ 38,747</u>	<u>\$ 38,006</u>	<u>\$ 741</u>	1.9%

Software license revenues increased slightly primarily due to improved sales execution and an increase in the number of software license transactions, offset by the continued weakness in information technology spending for PLM software and fewer software license transactions in excess of \$1.0.

Software license revenues decreased in North America during fiscal 2004 due to fewer software license transactions in excess of \$1.0 million as compared to the same period last year primarily due to the factors previously discussed. During fiscal 2003, software license revenues in North America included seven software license transactions in excess of \$1.0 million, compared to four during fiscal 2004. During fiscal 2004, software license revenues in Europe increased primarily as a result of two multi-million dollar software license transactions with new customers.

Software license revenues from our Matrix PLM Platform increased \$2.1 million in fiscal 2004 due to an increase in the number of software license transactions with new customers, which was offset by a \$1.3 million decrease in Business Process Applications revenues.

**Service revenues.** The components of our services revenues for fiscal 2004 and fiscal 2003 were as follows:

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 3, 2004	June 28, 2003		
	(As Restated)	(As Restated)		
Maintenance revenues.....	\$ 34,469	\$ 32,357	\$ 2,112	6.5%
Professional services revenues.....	34,398	32,645	1,753	5.4%
Training revenues .....	1,963	2,013	(50)	(2.5)%
Total service revenues .....	<u>\$ 70,830</u>	<u>\$ 67,015</u>	<u>\$ 3,815</u>	5.7%
Maintenance as a percentage of service revenues .....	48.7%	48.3%	0.4%	—

Service revenues increased due to an increase in professional services and maintenance revenues. During fiscal 2004, maintenance revenues increased primarily due to an increase in our maintenance revenue base as a result of new software license transactions. Professional services revenues increased during fiscal 2004 primarily as a result of projects related to upgrading our installed base of customers to Matrix10, expansion of existing customer implementations and an increase in projects with new customers during the later periods of fiscal 2004. Training revenues fluctuate from period to period based on the timing of new and existing customers attending training classes and customer purchases of web-based training products.

**Cost of software licenses.**

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 3, 2004	June 28, 2003		
	(As Restated)	(As Restated)		
Cost of software licenses.....	\$ 3,223	\$ 3,363	\$ (140)	(4.2)%

Cost of software licenses decreased \$0.1 million due to a \$0.9 million decrease in royalties on our Enterprise Integration products primarily due to decreases in certain contractual royalty rates, offset by a \$0.7 million increase in Business Process Application royalties, primarily due to the introduction of a new application.

**Cost of services.**

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 3, 2004	June 28, 2003		
	(As Restated)	(As Restated)		
Cost of services.....	\$ 46,218	\$ 46,467	\$ (249)	(0.5)%

Personnel, recruiting, training, travel and depreciation expense decreased \$2.7 million as a result of our restructuring programs and cost saving initiatives. The reduction in these costs was primarily offset by a \$2.5 million increase in the cost of independent systems integrators.

**Gross profit.** The following sets forth certain information regarding the gross profit and gross margin on our software license and service revenues:

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 3, 2004 (As Restated)	June 28, 2003 (As Restated)		
Gross profit on software license revenues....	\$ 35,524	\$ 34,643	\$ 881	2.5%
Gross profit on service revenues .....	24,612	20,548	4,064	19.8%
Total gross profit .....	<u>\$ 60,136</u>	<u>\$ 55,191</u>	<u>\$ 4,945</u>	9.0%
Gross margin on software license revenues.....	91.7%	91.2%	0.5%	—
Gross margin on service revenues.....	34.7%	30.7%	4.0%	—
Total gross margin.....	54.9%	52.6%	2.3%	—
Percentage of total revenues derived from software license revenues .....	35.4%	36.2%	(0.8)%	—
Percentage of total revenues derived from service revenues .....	64.6%	63.8%	0.8%	—

Total gross profit and gross margin increased during fiscal 2004 primarily due to an increase in both gross margin and gross profit on service revenues as a result of our cost saving initiatives and an increase in the proportion of our service revenues derived from maintenance revenues. Gross margin on services increased during fiscal 2004 primarily due to a reduction in personnel, personnel recruiting and training, and travel costs as a result of our restructuring programs and cost saving initiatives and an increase in the proportion of our service revenues derived from maintenance revenues.

#### **Selling and marketing.**

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 3, 2004 (As Restated)	June 28, 2003 (As Restated)		
Selling and marketing expenses.....	\$ 36,621	\$ 41,530	\$ (4,909)	(11.8)%
Selling and marketing expenses as a percentage of total revenues.....	33.4%	39.5%	(6.1)%	—

Selling and marketing expenses decreased both in absolute dollars and as a percentage of total revenues primarily due to a \$4.6 million decrease in personnel and travel costs, as a result of our restructuring programs and cost saving initiatives, and a \$0.3 million decrease in expenses related to user group, trade shows and other events, which included the MatrixOne Global Customer Conference.



### Research and development.

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 3, 2004	June 28, 2003		
	(As Restated)	(As Restated)		
Research and development expenses .....	\$ 23,028	\$ 26,377	\$ (3,349)	(12.7)%
Research and development expenses as a percentage of total revenues.....	21.0%	25.1%	(4.1)%	—

Research and development expenses decreased both in absolute dollars and as a percentage of total revenues primarily due to a \$1.7 million decrease in personnel costs, a \$0.8 million decrease in facilities and other discretionary costs as a result of our restructuring programs and cost saving initiatives and a \$0.8 million decrease in third party development costs.

### General and administrative.

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 3, 2004	June 28, 2003		
	(As Restated)	(As Restated)		
General and administrative expenses.....	\$ 10,256	\$ 10,485	\$ (229)	(2.2)%
General and administrative expenses as a percentage of total revenues .....	9.4%	10.0%	(0.6)%	—

General and administrative expenses decreased both in absolute dollars and as a percentage of total revenues primarily due to a \$0.4 million change in our provision for doubtful accounts offset by a slight increase in other general expenses.

### Stock-based compensation.

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 3, 2004	June 28, 2003		
	(As Restated)	(As Restated)		
Stock-based compensation expenses .....	\$ 567	\$ 3,195	\$ (2,628)	(82.3)%
Stock-based compensation expenses as a percentage of total revenues.....	0.5%	3.0%	(2.5)%	—

Stock-based compensation decreased due to a decrease in amortization as a result of the termination of the vesting of certain stock options and the forfeitures of terminated employees' stock options primarily related to our restructuring programs. The remaining options subject to vesting became fully vested during the year ended July 3, 2004 and, therefore, deferred stock-based compensation was completely amortized during that year.

### Restructuring charges.

In October 2003, April 2003, and October 2002, we implemented restructuring programs to reduce our expenses.

### *October 2003 Restructuring Program*

As a result of disappointing financial results for the three months ended September 27, 2003 and continued weakness in information technology spending and global economic conditions and the related impact on our business, in October 2003 we implemented a restructuring program to reduce expenses to align our operations and cost structure with current and projected market conditions (the “October 2003 restructuring program”). This restructuring program primarily included a reduction in the number of employees across all functions and locations and the closure and consolidation of certain offices.

The October 2003 restructuring program included a reduction in workforce of 45 employees, consisting of 10 employees in cost of service revenues, 16 employees in selling and marketing, 13 employees in research and development and six employees in general and administration. The costs related to the reduction in workforce include severance, fringe benefits and other related costs. These severed employees were not required to render service in order to receive termination benefits and were not required to render service beyond the minimum retention period.

The October 2003 restructuring program also included costs related to the closure and consolidation of certain office facilities. During the three months ended January 3, 2004, we vacated these offices and entered into agreements with the lessors to terminate the leases before the original lease term and paid a lease termination fee. In conjunction with the consolidation of certain offices, we also incurred certain costs to relocate employees and office furniture and equipment.

The significant components of the October 2003 restructuring program and the related restructuring charges, non-cash adjustments, cash payments and remaining accrual as of July 3, 2004 were as follows:

(In thousands)	Facilities and		Total
	Employee Severance and Fringe Benefits	Other Associated Costs	
Restructuring charges – fiscal 2004 .....	\$ 1,304	\$ 508	\$ 1,812
Non-cash adjustments – fiscal 2004 .....	<u>(99)</u>	<u>(15)</u>	<u>(114)</u>
Adjusted restructuring charges .....	1,205	493	1,698
Cash payments – fiscal 2004 .....	<u>(1,205)</u>	<u>(493)</u>	<u>(1,698)</u>
Accrual balance as of July 3, 2004 .....	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

The October 2003 restructuring program was completed and all cash payments were made during fiscal 2004.

### *April 2003 Restructuring Program*

In April 2003, we reorganized certain of our operations to reduce expenses and to better align our management structure with our strategic initiatives (the “April 2003 restructuring program”). The April 2003 restructuring program consisted of the elimination of certain positions, primarily at the Vice President and Director level.

The April 2003 restructuring program included a reduction in workforce of 13 employees, consisting of seven employees in selling and marketing, four employees in research and development and two employees in general and administration. The costs related to the reduction in workforce include severance, fringe benefits and other related costs.

The significant components of the April 2003 restructuring program and the related restructuring charges, non-cash adjustments, cash payments and the remaining accrual as of July 2, 2005 and July 3, 2004 were as follows:

<b>(In thousands)</b>	<b>Employee Severance and Fringe Benefits</b>
Restructuring charge – fiscal 2003 .....	\$ 521
Cash payments – fiscal 2003 .....	<u>(265)</u>
Accrual balance as of June 28, 2003 .....	256
Cash payments – fiscal 2004 .....	<u>(259)</u>
Non-cash adjustments – fiscal 2004 .....	95
Accrual balance as of July 3, 2004 .....	<u>92</u>
Cash payments – fiscal 2005 .....	<u>(43)</u>
Accrual balance as of July 2, 2005 .....	<u>\$ 49</u>

The non-cash adjustments during fiscal 2004 reflect additional employee severance related costs. The April 2003 restructuring program was substantially completed during fiscal 2004. The remaining cash payment is expected to be made upon settlement of a dispute with an employee terminated pursuant to the plan.

#### *October 2002 Restructuring Program*

As a result of continued weakness in information technology spending and global economic conditions and the related impact on our business, in October 2002 we implemented a restructuring program to reduce expenses to align our operations and cost structure with market conditions (the “October 2002 restructuring program”). This restructuring program primarily included a reduction in the number of employees across all functions and locations, a reduction in the use of independent contractors across all functions and locations and the closure of excess facilities.

The October 2002 restructuring program included a reduction in workforce of 86 employees, consisting of 32 employees in cost of service revenues, 28 employees in selling and marketing, 17 employees in research and development and nine employees in general and administration. The costs related to the reduction in workforce include severance, fringe benefits and other related costs.

The October 2002 restructuring program also included facility and lease costs related to the closure of certain excess facilities that we have exited and the termination of certain automotive lease contracts.

The significant components of the October 2002 restructuring program and the related charges, non-cash adjustments, cash payments and the remaining accrual as of July 3, 2004 were as follows:

<b>(In thousands)</b>	<b>Employee Severance and Fringe Benefits</b>	<b>Facilities and Leases</b>	<b>Total</b>
Restructuring charges – fiscal 2003 .....	\$ 3,348	\$ 452	\$ 3,800
Non-cash adjustments – fiscal 2003 .....	<u>(520)</u>	<u>(135)</u>	<u>(655)</u>
Adjusted restructuring charges – fiscal 2003 .....	2,828	317	3,145
Cash payments – fiscal 2003 .....	<u>(2,464)</u>	<u>(198)</u>	<u>(2,662)</u>
Accrual balance as of June 28, 2003 .....	364	119	483
Cash payments – fiscal 2004 .....	<u>(384)</u>	<u>(57)</u>	<u>(441)</u>
Non-cash adjustments – fiscal 2004 .....	<u>20</u>	<u>(62)</u>	<u>(42)</u>
Accrual balance as of July 3, 2004 .....	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

The non-cash adjustments during fiscal 2004 reflect an unfavorable final settlement for an employee severance arrangement and favorable final settlement for certain lease arrangements. The October 2002 restructuring program was substantially completed during fiscal 2003, and the remaining cash payments were made during fiscal 2004.

**Asset impairment and disposal charges.** In conjunction with the October 2003 restructuring program, we evaluated the recoverability of certain of our assets. Based on this evaluation, we determined that certain capitalized software would not be recoverable due to our inability to utilize and maintain this software as a result of the termination of certain operational and technical personnel and the reorganization of certain departments. Accordingly, we recorded an asset impairment charge of \$1.2 million, which represented the net book value of this software as of the evaluation date. In addition, in conjunction with the closure and consolidation of certain office facilities, we abandoned or disposed of certain office equipment and leasehold improvements that could not be transferred to or used by the remaining offices and recorded an asset abandonment and disposal charge of \$0.5 million, which represented the net book value of these assets on the date of the abandonment or disposal.

#### **Other income (expense).**

(In thousands)	Year Ended		Increase (Decrease)	Percentage Increase (Decrease)
	July 3, 2004	June 28, 2003		
	(As Restated)	(As Restated)		
Other income (expense), net .....	\$ 1,393	\$ 1,908	\$ (515)	(27.0)%

Other income decreased primarily due to a decrease in interest income of \$0.8 million as a result of lower yields on our investments resulting from a decrease in market interest rates and lower levels of cash available for investment, partially offset by a \$0.3 million increase in realized and unrealized gains on foreign currency transactions.

**Provision for income taxes.** During fiscal 2003, we recorded provisions for income taxes of \$0.3 million related to minimum taxes in certain domestic and foreign tax jurisdictions.

#### **Liquidity and Capital Resources**

Our principal source of liquidity is our current cash and cash equivalents. Our ability to generate cash from operations is dependent upon our ability to generate revenue from licensing our software and providing related services, as well as our ability to manage our operating costs and net assets. A decrease in the demand for our software and related services or unanticipated increases in our operating costs would likely have an adverse effect on our liquidity and cash generated from operations. The following sets forth information relating to our liquidity:

(In thousands)	As of		Increase (Decrease)	Percentage Increase (Decrease)
	July 2, 2005	July 3, 2004		
		(As Restated)		
Cash and cash equivalents .....	\$ 107,677	\$ 118,414	\$ (10,737)	(9.1)%
Working capital.....	\$ 79,104	\$ 100,535	\$ (21,431)	(21.3)%

During fiscal 2005, our cash and cash equivalents and working capital decreased primarily due to our loss from operations and the cash paid for acquisitions.

The following sets forth information relating to the sources and uses of our cash.

(In thousands)	Year Ended		
	July 2, 2005	July 3, 2004 (As Restated)	June 28, 2003 (As Restated)
Net cash used in operating activities .....	\$ (2,580)	\$ (11,510)	\$ (11,820)
Net cash used in investing activities.....	\$ (8,377)	\$ (732)	\$ (1,884)
Net cash provided by financing activities .....	\$ 633	\$ 1,912	\$ 605
Three Months Ended			
Days sales outstanding .....	80	80	(As Restated)

Net cash used in operating activities for fiscal 2005 resulted primarily from our net loss and an increase in prepaid expenses and other current assets, offset by non-cash depreciation and amortization expenses, increases in deferred revenue and increases in accounts payable and accrued expenses, due to the timing of certain disbursements. Net cash used in operating activities for fiscal 2004 resulted primarily from our net loss, increases in our accounts receivable at July 3, 2004 due to an increase in our revenues during the fourth quarter of fiscal 2004 and a decrease in accounts payable and accrued expenses due to the timing of certain disbursements. This net use of cash was partially offset by non-cash depreciation, amortization expenses and non-cash stock based compensation.

Net cash used in investing activities for fiscal 2005 reflects net cash payments related to acquisitions aggregating approximately \$6.6 million for Synchronicity and Centor of \$4.6 million and \$2.0 million respectively, and our investments in computer hardware and software, leasehold improvements and office furniture and equipment of \$1.9 million. Net cash used in investing activities for fiscal 2004 reflects \$1.1 million of investments in computer hardware and software and leasehold improvements related to the consolidation of certain offices in conjunction with our October 2003 restructuring program. We expect that capital expenditures for the next 12 months will be approximately \$3.0 million, primarily for the acquisition of computer hardware and software.

Net cash provided by financing activities for fiscal 2005 includes the proceeds from stock option exercises and purchases of common stock under our employee stock purchase plan aggregating \$2.1 million offset by a \$1.5 million repayment of a line of credit assumed in the Synchronicity acquisition. Net cash provided by financing activities for fiscal 2004 consists of the proceeds from stock option exercises and purchases of common stock under our employee stock purchase plan of \$1.0 million and \$0.9 million, respectively.

We currently anticipate that our current cash and cash equivalents will be sufficient to fund our anticipated cash requirements for working capital and capital expenditures for at least the next 12 months. However, we may need to raise additional funds in order to fund an expansion of our business, develop new products, enhance existing products and services, or acquire complementary products, businesses or technologies. If additional funds are raised through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders may be reduced, our stockholders may experience additional dilution, and such securities may have rights, preferences or privileges senior to those of our stockholders. Additional financing may not be available on

terms favorable to us, or at all. If adequate funds are not available or are not available on acceptable terms, our ability to fund an expansion of our business, take advantage of unanticipated opportunities or develop or enhance our services or products would be significantly limited.

### **Recently Issued Accounting Pronouncements**

Beginning in fiscal 2006, we will be required to adopt Statement of Financial Accounting Standards No. 123(R) "Share-Based Payments" ("SFAS 123(R)"), which requires all share-based payments to employees, including stock options and stock issued under certain employee stock purchase plans, to be recognized in the financial statements at their fair value. SFAS 123(R) will require us to estimate future forfeitures of stock based compensation, while the current pro forma disclosure includes only those options that have been forfeited during the current period. We will use the Black-Scholes option pricing model to determine fair value of options under SFAS 123(R) and have elected to use the modified-prospective transition method. Therefore, prior period financial statements will not be restated but disclosure of the pro forma net loss calculation will be included in the footnotes to the financial statements for periods prior to fiscal 2006 and the adoption of SFAS 123(R). The impact of adopting SFAS 123(R) cannot be accurately estimated at this time because the calculation depends on the market value and amount of share based awards granted in future periods.

On July 1, 2005, we accelerated the vesting of substantially all outstanding, unvested "out-of-the-money" options held by employees, officers and directors with exercise prices of at least \$5.75 per share, which was equal to 115% of the \$5.00 closing price of our common stock on the NASDAQ National Market on June 30, 2005. The vesting of options to purchase approximately 1.8 million shares of common stock with exercise prices ranging from \$5.82 per share to \$19.48 per share, with a weighted average exercise price of \$6.58 per share, were accelerated, including options to purchase approximately 495,000 shares held by executive officers and options to purchase 15,000 shares held by non-employee directors. The primary purpose of this vesting acceleration is to avoid recognizing stock-based compensation under SFAS 123(R) associated with these "out-of-the-money" options.

On December 21, 2004, the FASB issued Staff Position No. FAS 109-2, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004 (FSP FAS 109-2). The American Jobs Creation Act ("AJCA") introduces a special one-time dividends received deduction on the repatriation of certain foreign earnings to a U.S. taxpayer (repatriation provision), provided certain criteria are met. FSP FAS 109-2 provides accounting and disclosure guidance for the repatriation provision. Although FSP FAS 109-2 was effective immediately, the standard allows additional time beyond the financial reporting period of enactment to evaluate the effect of the AJCA on our plan for reinvestment or repatriation of foreign earnings for purposes of applying SFAS No. 109. We are currently evaluating the merits of repatriating funds under the AJCA and have not yet determined the impact of this statement on us. It has been our practice to indefinitely reinvest all foreign earnings into our foreign operations. Should we determine that we plan to repatriate any of our foreign earnings, we will be required to establish a deferred tax liability on such earnings through a charge to our income tax provision.

## Commitments and Contractual Obligations

Our commitments and contractual obligations for which we guarantee or contract for a minimum amount of fees primarily consist of operating leases for facilities, automobiles and office equipment, product development agreements under which we pay software license fees to third-parties for development or assistance in development of certain Business Process Applications and Enterprise Integration software and other contractual arrangements to support certain programs or activities. Our commitments and contractual obligations for which we guarantee or have minimum fees due consisted of the following as of July 2, 2005:

(In thousands)	2006	2007	2008	2009	2010	Thereafter
Leases .....	\$ 4,695	\$ 3,504	\$ 2,891	\$ 2,147	\$ 1,906	\$ 991
Development agreements .....	1,917	—	—	—	—	—
Minimum royalty fees .....	431	13	—	—	—	—
Other contractual arrangements.....	506	411	—	—	—	—
	<u>\$ 7,549</u>	<u>\$ 3,928</u>	<u>\$ 2,891</u>	<u>\$ 2,147</u>	<u>\$ 1,906</u>	<u>\$ 991</u>

We do not have any other commitments or contractual obligations in addition to those set forth above and those included in our Consolidated Financial Statements as of July 2, 2005.

## Off-Balance Sheet Arrangements

We did not have any off-balance sheet arrangements as of July 2, 2005.

## Income Taxes

As of July 2, 2005, we had available U.S. federal and state net operating loss ("NOL") carryforwards of approximately \$153.9 million and \$0.3 million of available U.S. federal and state tax credits to reduce future U.S. income taxes. These NOLs include deductions of approximately \$8.5 million related to certain stock option exercises. The tax benefit from the NOLs related to the exercise of stock options will be recorded as an increase to additional paid in capital as these NOLs are utilized. The NOLs and tax credit carryforwards expire in varying amounts commencing in fiscal 2006 through fiscal 2025, if not utilized. Use of these NOLs and tax credits may be limited due to certain changes in ownership.

As of July 2, 2005, we had NOL carryforwards in certain foreign countries aggregating \$41.5 million subject to certain limitations. These NOLs include deductions of approximately \$5.4 million related to certain stock option exercises. The tax benefit from the NOLs related to the exercise of stock options will be recorded as an increase to additional paid in capital as these NOLs are utilized. These NOLs expire in varying amounts commencing in fiscal 2006 if not utilized.

Our foreign subsidiary undistributed earnings were \$0 at July 2, 2005 and \$0.7 million at July 3, 2004. We do not provide U.S. taxes on our foreign subsidiaries' undistributed earnings.

We have recorded a valuation allowance against our deferred tax assets due to the fact it is more likely than not that these deferred tax assets will not be realized. We regularly evaluate the realizability of our deferred tax assets and may adjust the valuation allowance based on such analysis.

## Risk Factors

*This Annual Report on Form 10-K contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that involve risks and uncertainties. Our actual results could differ materially from those anticipated or projected in these forward-looking statements as a result of certain factors, including those set forth in the following cautionary statements and elsewhere in this Annual Report on Form 10-K. If any of the following risks were to occur, our business, financial condition or results of operations would likely suffer. In that event, the trading price of our common stock would decline. Any forward looking statement should be considered in light of the factors discussed below.*

*We have Identified Material Weaknesses in Our Disclosure Controls and Procedures and Our Internal Control Over Financial Reporting as of July 2, 2005 that, if Not Remedied Effectively, Could Result in Material Misstatements in our Financial Statements in Future Periods.*

Our management is responsible for establishing and maintaining adequate internal control over financial reporting for our Company, as defined in Rule 13a-15(f) or 15d-15(f) promulgated under the Securities Exchange Act of 1934, as amended. Our management assessed the effectiveness of our internal control over financial reporting as of July 2, 2005, and identified material weaknesses. Our management also evaluated the effectiveness of our disclosure controls and procedures and, due to these material weaknesses, our disclosure controls and procedures were not effective as of July 2, 2005.

A material weakness is defined by as a control deficiency, or combination of significant control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

We identified the following material weaknesses as of July 2, 2005:

- inadequate communication and monitoring of policies and procedures;
- inadequate staffing and lack of certain requisite skills within the finance and accounting organization; and
- inadequate processes, personnel with requisite skills and competencies, and oversight to identify the full scope of our arrangements with our customers.

For further information about these material weaknesses, please see “Management’s Report on Internal Control over Financial Reporting” and “Item 9A. Controls and Procedures” included elsewhere in this Annual Report on Form 10-K. Because of these material weaknesses, management concluded that, as of July 2, 2005, our internal control over financial reporting was not effective based on criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control-Integrated Framework.

We have implemented and continue to implement a number of remedial measures designed to address the material weaknesses identified as of July 2, 2005. If these remedial initiatives are insufficient to address the identified material weaknesses, or if additional material weaknesses or significant deficiencies in our internal control are discovered in the future, we may fail to meet our future reporting obligations on a timely basis, our financial statements may contain material misstatements, our operating results may be harmed, we may fail to meet our future reporting obligations on a timely basis, we may be subject to litigation, and our common stock may be delisted from the Nasdaq National Market. Any failure to address the identified material weaknesses or any additional material weaknesses or significant deficiencies in our internal control could also adversely affect the results of future management evaluations and auditor attestation reports regarding the effectiveness of our “internal control over financial reporting” that are required under Section 404 of the Sarbanes-Oxley Act of 2002. Internal control deficiencies could also cause investors to lose confidence in our reported financial information. We can give no assurance that the measures we have taken to date or any future measures we may take will remediate the material weaknesses identified or that any additional material weaknesses will not arise in the future



due to a failure to implement and maintain adequate internal control over financial reporting or circumvention of these controls. In addition, even if we are successful in strengthening our controls and procedures, those controls and procedures may not be adequate to prevent or identify irregularities or facilitate the fair presentation of our financial statements or our periodic reports filed with the SEC.

*Failure or Circumvention of Our Internal Controls and Procedures Could Seriously Harm Our Business.*

Our internal controls and procedures have been circumvented in the past and may be circumvented in the future. We are making significant changes in our internal control over financial reporting and our disclosure controls and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, and not absolute, assurances that the objectives of the system are met. The failure or circumvention of our controls, policies and procedures could have a material adverse effect on our business, results of operations and financial condition.

*Our Financial Statements Have been Impacted, and Could Be Impacted Again, by Unauthorized and Improper Actions of Our Personnel*

We recently restated previously released financial statements for fiscal 1999 through the second quarter of fiscal 2005, which was in part due to activities known to personnel employed at our Japanese subsidiary and concealed from U.S. management. Our financial statements could be adversely impacted by our employees' improper activities and unauthorized actions and their concealment of those activities. For instance, revenue recognition depends on, among other criteria, the terms negotiated in our contracts with our customers. Our personnel may act outside of their authority, such as by negotiating additional terms or modifying terms, without our knowledge that could impact our ability to recognize revenue in a timely manner, and they could commit us to obligations or arrangements that may have a serious financial impact to our results of operations or financial condition. We have implemented policies we hope will prevent and discourage such conduct, but there can be no assurance that such policies will be followed. In addition, depending on when we learn of improper activities or unauthorized actions, we may have to restate our financial statements for a previously reported period, which would seriously harm our business, operating results and financial condition.

*If We Are Not Current in Our Filings with the SEC, We Will Face Several Adverse Consequences.*

If we are unable to remain current in our financial filings, we will not be able to have a registration statement under the Securities Act of 1933, covering a public offering of securities, declared effective by the SEC, and we will not be able to make offerings pursuant to existing registration statements or pursuant to certain "private placement" rules of the SEC under Regulation D, to any purchasers not qualifying as "accredited investors." Finally, we will not be eligible to use a "short form" registration statement on Form S-3 for a period of 12 months after the time we become current in our filings. These restrictions may impair our ability to raise funds in the public markets, should we desire to do so, and to attract and retain key employees.

*If We Fail to Keep Current in Our Filings with the SEC, Our Common Stock May Be Delisted from the Nasdaq National Market and Transferred to the National Quotation Service Bureau ("Pink Sheets"), which May, Among Other Things, Reduce the Price of Our Common Stock and the Levels of Liquidity Available to Our Stockholders.*

If we fail to keep current in our filings with the SEC, our common stock may be delisted from the NASDAQ National Market and subsequently would trade on the Pink Sheets. The trading of our common stock on the Pink Sheets may reduce the price of our common stock and the levels of liquidity available to our stockholders. In addition, the trading of our common stock on the Pink Sheets will materially adversely affect our access to the capital markets, and the limited liquidity and reduced price of our common stock could materially adversely affect our ability to raise capital through alternative financing sources on terms acceptable to us or at all. Stocks that trade on the Pink Sheets are no longer eligible for margin loans, and a company trading on the Pink Sheets cannot avail itself of federal preemption of state securities or "blue sky" laws, which adds substantial compliance costs to

securities issuances, including pursuant to employee option plans, stock purchase plans and private or public offerings of securities. Our delisting from the NASDAQ National Market and transfer to the Pink Sheets may also result in other negative implications, including the potential loss of confidence by suppliers, customers and employees, the loss of institutional investor interest and fewer business development opportunities.

*We Have a History of Losses, and We May Incur Losses in the Future and May Not Achieve or Maintain Profitability*

We have incurred substantial net losses in the past, and we may incur net losses in future periods. We incurred net losses of approximately \$20.3 million, \$12.4 million and \$28.2 million in fiscal 2005, 2004 and 2003, respectively. As of July 2, 2005, we had an accumulated deficit of approximately \$128.1 million. We will need to generate increases in revenues to achieve and maintain profitability, and we may not be able to do so. If our revenues grow more slowly than we anticipate or decline or if our operating expenses increase more than we expect or cannot be reduced in the event of lower revenues, our business will be significantly and adversely affected. Although we have implemented restructuring programs to better align our operations and cost structure with market conditions, these programs may not be sufficient for us to achieve profitability in any future period. Even if we achieve profitability in the future on a quarterly or annual basis, we may not be able to sustain or increase profitability. Failure to achieve profitability or achieve and sustain the level of profitability expected by investors and securities analysts may adversely affect the market price of our common stock.

*Our Quarterly Revenues and Operating Results Are Likely to Fluctuate and if We Fail to Meet the Expectations of Management, Securities Analysts or Investors, Our Stock Price Could Decline*

Our quarterly revenues and operating results are difficult to predict, have varied significantly in the past and are likely to fluctuate significantly in the future. We typically realize a significant percentage of our revenues for a fiscal quarter in the second half of the third month of the quarter. Accordingly, our quarterly results may be difficult or impossible to predict prior to the end of the quarter. Any inability to obtain sufficient orders or to fulfill shipments in the period immediately preceding the end of any particular quarter may cause the results for that quarter to fall short of our revenues expectations. Any disruption in our ability to conduct our business which occurs will likely have a material adverse effect on our operating results for that quarter. In addition, we base our current and future expense levels in part on our estimates of future revenues. Our expenses are largely fixed in the short term. We may not be able to adjust our spending quickly if our revenues fall short of our expectations. Accordingly, a shortfall in revenues in a particular quarter would have an adverse effect on our operating results for that quarter.

In addition, our quarterly operating results may fluctuate for many reasons, including, without limitation:

- changes in demand for our products and services, including seasonal differences;
- changes in the mix of our software license and service revenues;
- changes in the mix of the licensing of our Matrix PLM Platform, Business Process Applications, Enterprise Integration and Accelerator products;
- the amount of royalty payments due to third-parties on our Business Process Applications, Enterprise Integration and Accelerator software products;
- changes in the mix of domestic and international revenues;

- variability in the mix of professional services performed by us and systems integrators;
- the amount of training we provide to systems integrators and Alliance Partners related to our products and their implementation; and
- The application of complex revenue recognition rules for customer arrangements.

For these reasons, you should not rely on period-to-period comparisons of our financial results to forecast our future performance. It is likely that in some future quarter or quarters our operating results will be below the expectations of securities analysts or investors. If a shortfall in revenues occurs, the market price of our common stock may decline significantly.

*Our Lengthy and Variable Sales Cycle Makes it Difficult for Us to Predict When or if Sales Will Occur and Therefore We May Experience an Unplanned Shortfall in Revenues*

Our products have a lengthy and unpredictable sales cycle that contributes to the uncertainty of our operating results. Customers view the purchase of our software as a significant and strategic decision. As a result, customers generally evaluate our software products and determine their impact on existing infrastructure over a lengthy period of time. Our sales cycle has historically ranged from approximately one to nine months based on the customer's need to rapidly implement a solution and whether the customer is new or is extending an existing implementation. The license of our software products may be subject to delays if the customer has lengthy internal budgeting, approval and evaluation processes. We may incur significant selling and marketing expenses during a customer's evaluation period, including the costs of developing a full proposal and completing a rapid proof of concept or custom demonstration, before the customer places an order with us. Customers may also initially purchase a limited number of licenses before expanding their implementations. Larger customers may purchase our software products as part of multiple simultaneous purchasing decisions, which may result in additional unplanned administrative processing and other delays in the recognition of our license revenues. If revenues forecasted from a specific customer for a particular quarter are not realized or are delayed to another quarter, we may experience an unplanned shortfall in revenues, which could significantly and adversely affect our operating results.

*We May Not Achieve Our Anticipated Revenues if Large Software and Service Orders Expected in a Quarter Are Not Placed or Are Delayed*

Although we license our software to numerous customers in any quarter, a single customer may represent more than 10% of our quarterly revenues. We expect that revenues from large orders will continue to represent an increasing percentage of our total revenues in future quarters. A customer may determine to increase its number of licenses and expand its implementation of our software throughout its organization and to its customers, suppliers and other business partners only after a successful initial implementation. Therefore, the timing of these large orders is often unpredictable. If any large order anticipated for a particular quarter is not realized, delayed to another quarter or significantly reduced, we may experience an unplanned shortfall in revenues, which could significantly and adversely affect our operating results.

*If Our Existing Customers Do Not License Additional Software Products From Us, We May Not Achieve Growth in Our Revenues*

Our customers' initial implementations of our software often include a limited number of licenses. Customers may subsequently add licenses as they expand the implementations of our products throughout their enterprises or add software applications designed for specific functions. Therefore, it is important that our customers are satisfied with their initial product implementations. If we do not increase licenses to existing customers, we may not be able to achieve growth in our revenues, which could significantly and adversely affect our operating results.

*We Must Overcome Significant Challenges in Integrating Business Operations and Product Offerings to Realize the Benefits of Our Recent Acquisitions*

We will not achieve the anticipated benefits of our acquisitions unless we successfully combine and integrate the business operations and products of the three companies in a timely and effective manner. Integration will be a complex, time-consuming and expensive process and may result in revenue disruption and operational difficulties. We must operate as a combined organization utilizing common information communication systems, operating procedures, financial controls and human resource practices. We may experience substantial difficulties, costs and delays involved in the integration of our acquisitions. These difficulties, costs and delays may include:

- the difficulty of incorporating acquired technology into our products and services;
- the disruption of our ongoing business and diversion of management resources;
- an incompatibility of the business cultures;
- unanticipated expenses related to integration of operations;
- the impairment of relationships with employees and customers due to integration of new personnel;
- the difficulties of integrating international and domestic operations;
- unknown liabilities associated with the acquired business and technology;
- costs and delays in implementing common systems and procedures, including financial accounting systems and customer information systems, and disclosure controls and internal controls over financial reporting; and
- inability to retain, integrate and motivate key management, marketing, technical sales and customer support and development personnel.

We may not succeed in addressing these risks or any other problems encountered in connection with the integration of these acquisitions. If we are not successful in integrating our acquisitions, we may not realize the anticipated benefits of the acquisitions and the market price of our common stock may decline.

We operate in a highly competitive environment, characterized by rapid technological change and evolution of standards and frequent new product introductions. To obtain the full potential benefits of our acquisitions, we must promptly integrate our business operations, technology and product offerings. We cannot assure you that we will be able to integrate their technology offerings and operations quickly and smoothly. We may be required to spend additional time or money on integration that would otherwise be spent on developing our business or on other matters. If we do not integrate our operations and technology smoothly or if management spends too much time on integration issues, it could harm our business, financial condition and results of operations and diminish the benefits of the acquisition as well as harm our existing business.

*There May Be Sales of Substantial Amounts of Our Common Stock Issued in Connection with Our Acquisition of Synchronicity Which Could Cause Our Stock Price to Fall*

As part of the aggregate purchase price to acquire Synchronicity, we issued approximately 2.3 million shares of our common stock, which may be resold under Rule 144 under the Securities Act. A substantial number of shares of our common stock may be sold into the public market, which could therefore result in a sharp decline in the market price of our common stock. In addition, the sale of these shares could impair our ability to raise capital through the sale of additional common stock.

*Future Acquisitions May Negatively Affect Our Ongoing Business Operations and Our Operating Results*

We may further expand our operations or market presence by acquiring or investing in additional businesses, products or technologies that complement our business, increase our market coverage, enhance our technical capabilities or otherwise offer opportunities for growth. These transactions create risks such as:

- difficulty assimilating the operations, technology, products and personnel we acquire;
- disruption of our ongoing business;
- diversion of management's attention from other business concerns;
- one-time charges and expenses associated with amortization of purchased intangible assets; and
- potential dilution to our stockholders.

Our inability to address these risks could negatively impact our operating results. Moreover, any future acquisitions, even if successfully completed, may not generate any additional revenues or provide any benefit to our business.

*The Market for Our PLM Software Is Rapidly Changing and Demand for PLM Software Could Decline*

The market for PLM software is rapidly changing. We cannot be certain that this market will continue to develop and grow or that companies will choose to use our products rather than attempting to develop alternative platforms and applications internally or through other sources. If we fail to establish a significant base of customer references, our ability to market and license our products successfully may be reduced. Companies that have already invested substantial resources in other methods of sharing information during the design, manufacturing and supply process may be reluctant to adopt new technology or infrastructures that may replace, limit or compete with their existing systems or methods. We expect that we will continue to need to pursue intensive marketing and selling efforts to educate prospective customers about the uses and benefits of our products. Therefore, demand for and market acceptance of our software products is subject to a high level of uncertainty.

*If We Are Not Successful in Developing New Products and Services that Keep Pace with Technology, Our Operating Results Will Suffer*

The market for our software is characterized by rapid technological advances, changing customer needs and evolving industry standards. Accordingly, to realize our expectations regarding our operating results, we depend on our ability to:

- develop, in a timely manner, new software products and services that keep pace with developments in technology;
- meet evolving customer requirements; and

- enhance our current product and service offerings and deliver those products and services through appropriate distribution channels.

We may not be successful in developing and marketing, on a timely and cost-effective basis, either enhancements to our products or new products that respond to technological advances and satisfy increasingly sophisticated customer needs. If we fail to introduce new products, our operating results will suffer. In addition, if new industry standards emerge that we do not anticipate or adapt to, our software products could be rendered obsolete and our business could be materially harmed.

*We May Not Achieve Anticipated Revenues if Market Acceptance of Our Software Does Not Continue*

We believe that revenues from licenses of our software, together with revenues from related professional services, training and maintenance and customer support services, will account for substantially all of our revenues for the foreseeable future. Our future financial performance will depend on market acceptance of our software, including our Matrix PLM Platform, Business Process Applications, Enterprise Integration and Accelerator products, and any upgrades or enhancements that we may make to our products in the future. As a result, if our software does not achieve and maintain widespread market acceptance, we may not achieve anticipated revenues. In addition, if our competitors release new products that are superior to our software, demand for our products may not accelerate and could decline. If we are unable to increase the number and scope of our Business Process Applications, Enterprise Integration and Accelerator products or ship or implement any upgrades or enhancements to our products when planned, or if the introduction of upgrades or enhancements causes customers to defer orders for our existing products, we also may not achieve anticipated revenues.

*We Will Not Succeed Unless We Can Compete in Our Markets*

The markets in which we offer our software and services are intensely competitive and rapidly changing. Furthermore, we expect competition to intensify, given the newly emerging nature of the market for PLM software and consolidation in the software industry in general. We will not succeed if we cannot compete effectively in these markets. Competitors vary in size and in the scope and breadth of the products and services they offer. Many of our actual or potential competitors have significant advantages over us, including, without limitation:

- larger and more established selling and marketing capabilities;
- significantly greater financial, engineering and other resources;
- greater name recognition and a larger installed base of customers; and
- well-established relationships with our existing and potential customers, systems integrators, complementary technology vendors and Alliance Partners.

As a result, our competitors may be in a stronger position to respond quickly to new or emerging technologies and changes in customer requirements. Our competitors may also be able to devote greater resources to the development, promotion and sale of their products and services than we can. Accordingly, we may not be able to maintain or expand our revenues if competition increases and we are unable to respond effectively.

As competition in the PLM software market intensifies, new solutions will come to market. Our competitors may package their products in a manner that may discourage customers from licensing our software. Also, current and potential competitors may establish cooperative relationships among themselves or with third-parties or adopt aggressive pricing policies to gain market share. Consolidation in the industry also results in larger competitors that may have significant combined resources with which to compete against us. Increased competition could

result in reductions in price and revenues, lower profit margins, loss of customers and loss of market share. Any one of these factors could materially and adversely affect our business and operating results.

*We Depend on Licensed Third-Party Technology, and the Ability to Interoperate with Third Party Technology, the Loss of Which Could Adversely Impact the Licensing of Our Products, or Result in Increased Costs of or Delays in Licensing Our Products*

We license technology from several companies on a non-exclusive basis that is integrated into many of our products. We also license certain Enterprise Integration products from third-parties for the purposes of enabling our products to interoperate with third party application products. We anticipate that we will continue to license technology from third-parties in the future. This software may not continue to be available on commercially reasonable terms, or at all. Some of the software we license from third-parties would be difficult and time-consuming to replace. The loss of any of these technology licenses could result in delays in the licensing of our products until equivalent technology, if available, is identified, licensed and integrated. The loss of the ability to integrate to any of the third party products could also adversely impact the licensing of our products. In addition, the effective implementation of our products may depend upon the successful operation of third-party licensed products in conjunction with our products, and therefore any undetected errors in these licensed products may prevent the implementation or impair the functionality of our products, delay new product introductions or injure our reputation.

*We Could Incur Substantial Costs Defending Our Intellectual Property from Claims of Infringement*

The software industry is characterized by frequent litigation regarding copyright, patent and other intellectual property rights. We may be subject to future litigation based on claims that our products infringe the intellectual property rights of others or that our own intellectual property rights are invalid. We expect that software product developers will increasingly be subject to infringement claims as the number of products and competitors in our industry grows and the functionality of products overlaps. From time to time, we have received correspondence from competitors asserting potential infringement of intellectual property rights or other claims based upon the integration of our software with one or more of their software offerings; such integrations are typically performed at the request of mutual customers. Claims of infringement could require us to reengineer or rename our products or seek to obtain licenses from third-parties in order to continue offering our products. Licensing or royalty agreements, if required, may not be available on terms acceptable to us or at all. Even if successfully defended, claims of infringement could also result in significant expense to us and the diversion of our management and technical resources.

*Our Revenues Could Decline if We Do Not Develop and Maintain Successful Relationships with Systems Integrators, Complementary Technology Vendors and Alliance Partners*

We pursue business alliances with systems integrators, complementary technology vendors and Alliance Partners to endorse our software, implement our software, provide customer support services, promote and resell products that integrate with our products and develop industry-specific software products. These alliances provide an opportunity to license our products to our Alliance Partners' installed customer bases. In many cases, these parties have established relationships with our existing and potential customers and can influence the decisions of these customers. We rely upon these companies for recommendations of our products during the evaluation stage of the purchasing process, as well as for implementation and customer support services. A number of our competitors have strong relationships with these systems integrators, complementary technology vendors and Alliance Partners who, as a result, may be more likely to recommend our competitors' products and services. In addition, some of our competitors have relationships with a greater number of these systems integrators, complementary technology vendors and Alliance Partners and, therefore, have access to a broader base of enterprise customers. If we are unable to establish, maintain and strengthen these relationships, we will have to devote substantially more resources to the selling and marketing, implementation and support of our products. Our efforts may not be as effective as these systems integrators, complementary technology vendors and Alliance Partners, which could significantly harm our operating results.

*We May Not Be Able to Increase Revenues if We Do Not Expand Our Sales and Distribution Channels and Improve Our Sales Productivity*

We will need to expand our direct and indirect global sales operations and improve our sales productivity in order to increase market awareness and acceptance of our software and generate increased revenues. We market and license our products directly through our sales organization and indirectly through our global Alliance Partner and distributor network.

Our ability to increase our global direct sales organization will depend on our ability to recruit, train and retain sales personnel with advanced sales skills and technical knowledge. Competition for qualified sales personnel is intense in our industry. In addition, it may take up to nine months for a new sales person to become fully productive. If we are unable to hire or retain qualified sales personnel, or if newly hired or existing sales personnel fail to develop the necessary skills, reach productivity more slowly than anticipated or are not able to maintain an expected level of productivity, we may have difficulty licensing our products, and we may experience a shortfall in anticipated revenues.

In addition, we believe that our future success is dependent upon expansion of our indirect global distribution channel, which consists of our relationships with a variety of systems integrators, complementary technology vendors and distributors. We cannot be certain that we will be able to maintain our current relationships or establish relationships with additional distribution partners on a timely basis, or at all. Our distribution partners may not devote adequate resources to promoting or selling our products and may not be successful. In addition, we may also face potential conflicts between our direct sales force and third-party reselling efforts. Any failure to expand our indirect global distribution channel or increase the productivity of this distribution channel could result in lower than anticipated revenues.

*Our International Operations Expose Us to Business Risks Which Could Cause Our Operating Results to Suffer*

Our international revenues and expenses are generally transacted by our foreign subsidiaries in their respective countries and are typically denominated in local currency. Approximately 35.8%, 40.9% and 35.4% of our total revenues for fiscal 2005, 2004 and 2003, respectively, were from our foreign subsidiaries. In addition, approximately 26.6%, 29.0% and 27.2% of our expenses for fiscal 2005, 2004 and 2003, respectively, were from our foreign subsidiaries. At July 2, 2005 and July 3, 2004, approximately 23.9% and 18.6%, respectively, of our total assets were located at our foreign subsidiaries. Many of our customers have operations in numerous locations around the globe. In order to attract, retain and service multi-national customers, we have to maintain strong direct and indirect sales and support organizations in Europe and Asia/Pacific. Our ability to penetrate international markets may be impaired by resource constraints and our ability to hire qualified personnel in foreign countries. We face a number of risks associated with conducting business internationally, which could negatively impact our operating results, including, without limitation:

- difficulties relating to the management, administration and staffing of a globally-dispersed business;
- difficulties managing the operations of a globally-dispersed business and developing, implementing and monitoring systems of internal controls, including disclosure controls and internal controls over financial reporting;
- longer sales cycles associated with educating foreign customers on the benefits of our products and services;
- longer accounts receivable payment cycles and difficulties in collecting accounts receivable;
- difficulties in providing customer support for our products in multiple time zones;



- currency fluctuations and exchange rates;
- limitations on repatriation of earnings of our foreign operations;
- the burdens of complying with a wide variety of foreign laws;
- reductions in business activity during the summer months in Europe and certain other parts of the world;
- multiple and possibly overlapping tax structures;
- negative tax consequences such as withholding taxes and employer payroll taxes;
- language barriers;
- the need to consider numerous international product characteristics;
- different accounting practices;
- import/export duties and tariffs, quotas and controls;
- complex and inflexible employment laws;
- economic or political instability in some international markets; and
- conflicting international business practices.

We believe that expansion into new international markets will be necessary for our future success. Therefore, a key aspect of our strategy is to continue to expand our presence in foreign markets. We may not succeed in our efforts to enter new international markets. If we fail to do so, we may not be able to maintain existing levels of revenues and promote growth in our revenues. This international expansion may be more difficult or time-consuming than we anticipate. It is also costly to establish and maintain international facilities and operations and promote our products internationally. Thus, if revenues from international activities do not offset the expenses of establishing and maintaining foreign operations, our operating results will suffer.

*Our Services Revenues and Operating Results May Be Adversely Affected if We Are Not Able to Maintain the Billing and Utilization Rates for Our Professional Services Personnel*

The billing rates we charge for our professional services and the utilization, or chargeability, of our professional services personnel are significant components of our services revenues, gross margin and operating results. Our billing rates are affected by a number of factors, including the introduction of new services or products by our competitors, the pricing policies of our competitors, demand for professional services and general economic conditions. Our utilization rates are also affected by a number of factors, including seasonal trends, the duration and complexity of an engagement, our ability to transition employees from completed professional services engagements to new engagements and our ability to forecast demand of our professional services and thereby maintain an appropriate headcount. Many of the above factors are beyond our control.

Accordingly, if we are not able to maintain the rates we charge for our professional services or an appropriate utilization for our professional services personnel, our service revenues and gross profit are likely to decline, which would adversely affect our operating results.

*We Occasionally Perform Professional Services Engagements on a Fixed-Price Basis, Which Could Cause a Decline in Our Gross Margins*

We occasionally perform professional services engagements on a fixed-price basis. Prior to performing a fixed-price professional services engagement, we estimate the amount of work involved for the engagement. However, we may underestimate the amount of time or resources required to complete a professional services engagement, and we may not be able to charge the customer for the additional work performed. If we do not correctly estimate the amount of time or resources required for a professional services engagement and we are not able to charge the customer for the additional work performed, our gross profit would decline, which would adversely affect our operating results.

*If Systems Integrators Are Not Available or Fail to Perform Adequately, Our Customers May Suffer Implementation Delays and a Lower Quality of Customer Service, and We May Incur Increased Expenses*

Systems integrators often are retained by our customers to implement our products. If experienced systems integrators are not available to implement our products, we may be required to provide these services internally, and we may not have sufficient resources to meet our customers' implementation needs on a timely basis. Use of our professional services personnel to implement our products would also increase our expenses. In addition, we cannot control the level and quality of service provided by our current and future implementation partners. If these systems integrators do not perform to the satisfaction of our customers, our customers could become dissatisfied with our products, which could adversely affect our business and operating results.

*We Depend on Our Key Personnel to Manage Our Business Effectively, and if We Are Unable to Retain Key Personnel, Our Ability to Compete Could Be Harmed*

Our ability to implement our business strategy and our future success depends largely on the continued services of our executive officers and other key engineering, sales, marketing and support personnel who have critical industry or customer experience and relationships. The loss of the technical knowledge and management and industry expertise of any of these key personnel could result in delays in product development, loss of customers and sales and diversion of management resources, which could materially and adversely affect our operating results. In addition, our future performance depends upon our ability to attract and retain highly qualified sales, engineering, marketing, services and managerial personnel, and there is intense competition for such personnel. If we do not succeed in retaining our personnel or in attracting new employees, our business could suffer significantly.

*Our Products May Contain Defects that Could Harm Our Reputation, Be Costly to Correct, Delay Revenues and Expose Us to Litigation*

Despite testing by us, our Alliance Partners and our customers, errors may be found in our products after commencement of commercial shipments. We and our customers have from time to time discovered errors in our software products. In the future, there may be additional errors and defects in our software. If errors are discovered, we may not be able to successfully correct them in a timely manner or at all. Errors and failures in our products could result in loss of or delay in market acceptance of our products and damage to our reputation and our ability to convince commercial users of the benefits of our products. In addition, we may need to make significant expenditures of capital resources in order to eliminate errors and failures. Since our products are used by customers for mission-critical applications, errors, defects or other performance problems could also result in financial or other damages to our customers, who could assert warranty and other claims for substantial damages against us. Although our license agreements with our customers typically contain provisions designed to limit our exposure to potential product liability claims, it is possible that such provisions may not be effective or

enforceable under the laws of certain jurisdictions. In addition, our insurance policies may not adequately limit our exposure with respect to such claims. A product liability claim, even if unsuccessful, would be costly and time-consuming to defend and could harm our business.

*If We Are Unable to Obtain Additional Capital as Needed in the Future, Our Business May Be Adversely Affected and the Market Price for Our Common Stock Could Significantly Decline*

We have been unable to fund our operations using cash generated from our business operations and have financed our operations principally through the sale of securities. We may need to raise additional debt or equity capital to fund an expansion of our operations, to enhance our products and services, or to acquire or invest in complementary products, services, businesses or technologies. If we raise additional funds through further issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution, and any new equity securities we issue could have rights, preferences and privileges superior to those of holders of our common stock. In addition, we may not be able to obtain additional financing on terms favorable to us, if at all. If adequate funds are not available on terms favorable to us, our business may be adversely affected and the market price for our common stock could significantly decline.

*Our Business May be Adversely Affected by Securities Class Action Litigation*

On April 19, 2002, a consolidated amended class action complaint was filed in the United States District Court for the Southern District of New York. The complaint, which superseded five virtually identical complaints that had been filed from July 24, 2001 to September 5, 2001, named us as a defendant along with two of our officers, and certain underwriters involved in our initial public offering of common stock (“IPO”). The complaint is allegedly brought on behalf of purchasers of our common stock during the period from February 29, 2000 to December 6, 2000 and asserts, among other things, that our IPO prospectus and registration statement violated federal securities laws because they contained material misrepresentations and/or omissions regarding the conduct of our IPO underwriters in allocating shares in our IPO to the underwriters’ customers. The action seeks damages, fees and costs associated with the litigation, and interest. We and our officers and directors believe that the allegations in the complaint are without merit and have defended the litigation vigorously. In June 2003, the Company, implementing the determination made by a special independent committee of the Board of Directors, elected to participate in a proposed settlement agreement with the plaintiffs in this litigation which must be approved the court. The litigation process is inherently uncertain and unpredictable, however, and there can be no guarantee as to the ultimate outcome of this pending lawsuit.

In the past, securities class action litigation has often been brought against a company following periods of volatility in the price of its securities. Due to the volatility of our stock price, we may be the target of securities litigation in the future. In addition, securities class actions often have been brought in connection with restatements of financial statements. We recently restated previously released financial statements for the period of fiscal 1999 through the second quarter of fiscal 2005. The expense of defending and the outcome of pending and future shareholder litigation, including the New York securities litigation described above, and the possible inadequacy of our insurance to cover its obligations with respect to the ultimate resolution of any pending or future litigation matters could have a material adverse effect on our operating results. Securities litigation could also divert management’s attention and resources from our business, which could have a material adverse effect on our business and operating results.

This Annual Report on Form 10-K contains restated financial statements for fiscal 1999 through the second quarter of fiscal 2005. Defending against potential litigation relating to the restatement of our consolidated financial statements could have a material adverse effect on our business, results of operations and financial condition and require significant attention and resources of management. Regardless of the outcome, such litigation could result in significant legal expenses and may also negatively affect our relationships with our customers and employees.

*Any Securities Litigation Relating to the Restatement of Our Financial Statements Could have a Material Adverse Effect on Our Business, Financial Condition and Results of Operations.*

Defending against potential litigation relating to the restatement of our consolidated financial statements could have a material adverse effect on our business, results of operations and financial condition and require significant attention and resources of management. Regardless of the outcome, such litigation could result in significant legal expenses and may also negatively affect our relationships with our customers and our employees.

*Failure to Protect Our Intellectual Property Could Harm Our Name Recognition Efforts and Ability to Compete Effectively*

Currently, we rely on a combination of trademarks, patents, copyrights and common law safeguards, including trade secret protection to protect our intellectual property rights. To protect our intellectual property rights in the future, we intend to rely on a combination of patents, trademarks, copyrights and common law safeguards, including trade secret protection. We also rely on restrictions on use, confidentiality and nondisclosure agreements and other contractual arrangements with our employees, affiliates, customers, Alliance Partners and others. The protective steps we have taken may be inadequate to deter misappropriation of our intellectual property and proprietary information. A third-party could obtain our proprietary information or develop products or technology competitive with ours. We may be unable to detect the unauthorized use of, or take appropriate steps to enforce, our intellectual property rights. We have registered some of our trademarks in the United States and abroad, have several patents issued and have other trademark and patent applications pending or in preparation. Effective patent, trademark, copyright and trade secret protection may not be available in every country in which we offer or intend to offer our products and services to the same extent as in the United States. Failure to adequately protect our intellectual property could harm or even destroy our brands and impair our ability to compete effectively. Further, enforcing our intellectual property rights could result in the expenditure of significant financial and managerial resources and may not prove successful.

*Our Stock Price Has Been and May Continue to be Volatile Which May Lead to Losses by Stockholders*

The trading price of our common stock has been highly volatile and has fluctuated significantly in the past. During fiscal 2005 our stock price fluctuated between a low bid price of \$3.87 per share and a high bid price of \$7.08 per share, and during fiscal 2004, our stock price fluctuated between a low bid price of \$4.08 per share and a high bid price of \$8.73 per share. We believe that the price of our common stock may continue to fluctuate significantly in the future in response to a number of events and factors relating to our Company, our competitors, the market for our products and services and the global economy, many of which are beyond our control, such as:

- variations in our quarterly operating results;
- changes in financial estimates and recommendations by securities analysts;
- changes in market valuations of software companies;
- announcements by us or our competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
- loss of a major customer or failure to complete significant business transactions;
- additions or departures of key personnel;
- the threat of additional litigation by current or former employees, customers, and shareholders;
- sales of a substantial number of shares of our common stock in the public market by existing shareholders;

- sales of common stock or other securities by us in the future;
- news relating to trends in our markets; and
- identification and disclosure of ineffective disclosure controls and procedures, including material weakness in internal controls over financial reporting.

In addition, the stock market in general, and the market for technology companies in particular, has experienced extreme volatility. This volatility has often been unrelated to the operating performance of particular companies. These broad market and industry fluctuations may adversely affect the market price of our common stock, regardless of our operating performance.

*Anti-Takeover Provisions in Our Organizational Documents and Delaware Law Could Prevent or Delay a Change in Control of Our Company*

Certain provisions of our certificate of incorporation and bylaws may discourage, delay or prevent a merger or acquisition that stockholders may consider favorable. These provisions may also prevent changes in our management. These provisions include, without limitation:

- authorizing the issuance of undesignated preferred stock;
- providing for a classified board of directors with staggered, three-year terms;
- requiring super-majority voting to effect certain amendments to our certificate of incorporation and bylaws;
- limiting the persons who may call special meetings of stockholders;
- prohibiting stockholder action by written consent; and
- establishing advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted on by stockholders at stockholder meetings.

Certain provisions of Delaware law may also discourage, delay or prevent someone from acquiring or merging with us.

## **ITEM 7A: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We have foreign subsidiaries in Austria, Canada, England, France, Germany, Italy, Japan, Korea, Singapore and the Netherlands. Our international revenues and expenses are generally transacted by our foreign subsidiaries in their respective countries and are typically denominated in local currency. Approximately 35.8%, 40.9% and 35.4% of our total revenues for fiscal 2005, 2004 and 2003, respectively, were from our foreign subsidiaries. In addition, approximately 26.6%, 29.0% and 27.2% of our expenses for fiscal 2005, 2004 and 2003, respectively, were from our foreign subsidiaries. At July 2, 2005 and July 3, 2004, approximately 23.9% and 18.6%, respectively, of our total assets were located at our foreign subsidiaries.

We are exposed to foreign currency exchange rate fluctuations as the financial results and balances of our foreign subsidiaries are translated into U.S. dollars. As exchange rates vary, these results, when translated, may vary from expectations and may adversely impact our results of operations and financial condition (“translation risk”). Therefore, we are exposed to both foreign currency exchange risks and fluctuations in foreign currencies, along with economic and political instability in the foreign countries in which we operate, all of which could adversely impact our results of operations and financial condition. We currently do not enter into contracts or agreements to minimize our exposure to the effects of changes in foreign currency when the results of our international subsidiaries are translated to U.S. Dollars. Accordingly, if the dollar weakens relative to foreign currencies, our revenues and expenses would increase when stated in U.S. Dollars. Conversely, if the dollar strengthens, our revenues and expenses would decrease.

Our exposure to foreign currency exchange rate fluctuations also arises in part from the payment of intercompany transactions. Our intercompany transactions are typically denominated in the local currency of the foreign subsidiary in order to centralize foreign currency risk at the parent company in the United States. The parent company and our foreign subsidiaries may also transact business in a currency other than the local currency. Our foreign currency hedging program is principally designed to mitigate the future potential impact of changes in the value of transactions denominated in a currency other than the local currency as a result of changes in foreign currency exchange rates, which may impact our results of operations. Our foreign currency hedging program is not designed, nor do we enter into foreign currency contracts, to mitigate translation risk. We use forward contracts to reduce our exposure to foreign currency risk due to fluctuations in exchange rates underlying the value of accounts receivable and accounts payable denominated in a currency other than the local currency and certain intercompany accounts receivable and intercompany accounts payable transactions designated for repayment. A forward contract obligates us to exchange predetermined amounts of specified foreign currencies at specified exchange rates on specified dates. These forward contracts are denominated in the same currency in which the underlying foreign currency receivables or payables are denominated and bear a contract value and maturity date that approximate the value and expected settlement date, respectively, of the underlying transactions. Unrealized gains and losses on open contracts at the end of each accounting period, resulting from changes in the fair value of these contracts, are recognized in earnings in the same period as gains and losses on the underlying foreign denominated receivables or payables are recognized and generally offset. Gains and losses on forward contracts and foreign denominated receivables and payables are included in other income (expense), net. We do not enter into or hold derivatives for trading or speculative purposes, and we only enter into forward contracts with highly rated financial institutions. At July 2, 2005 and July 3, 2004, there were no forward contracts outstanding.

We plan to continue our use of forward contracts and other instruments in the future to reduce our exposure to exchange rate fluctuations from accounts receivable and accounts payable denominated in a currency other than the local currency and certain intercompany accounts receivable and intercompany accounts payable transactions designated for repayment, and we may not be able to do this successfully. Accordingly, we may experience economic loss and a negative impact on our results of operations as a result of foreign currency exchange rate fluctuations. Also, as we continue to expand our operations outside of the United States, our exposure to fluctuations in currency exchange rates could increase.

We deposit our cash in highly rated financial institutions in North America, Europe and Asia/Pacific. We invest in diversified United States and international money market mutual funds and United States Treasury and agency securities. At July 2, 2005, we had \$77.2 million and \$2.8 million invested in the United States and Continental Europe, respectively. At July 2, 2005, the weighted average interest rate on our investments was 3.02% per annum. Due to the short-term nature of our investments, we believe we have minimal market risk.

Our investments are subject to interest rate risk. All of our investments have remaining maturities of three months or less. If these short-term assets were reinvested in a declining interest rate environment, we would experience an immediate negative impact on other income. The opposite holds true in a rising interest rate environment.

## ITEM 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Management's report on internal control over financial reporting is filed as part of this Annual Report on Form 10-K beginning on page M-1.

### MATRIXONE, INC.

#### Index to Consolidated Financial Statements

The following consolidated financial statements and the related notes thereto of MatrixOne, Inc. and the Reports of Independent Auditors thereon are filed as a part of this Annual Report on Form 10-K:

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Consolidated Statements of Operations for the years ended July 2, 2005, July 3, 2004 (as restated) and June 28, 2003 (as restated).....	64
Consolidated Statements of Stockholders' Equity for the years ended July 2, 2005, July 3, 2004 (as restated) and June 28, 2003 (as restated).....	65
Consolidated Statements of Cash Flows for the years ended July 2, 2005, July 3, 2004 (as restated) and June 28, 2003 (as restated).....	66
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## **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of MatrixOne, Inc.:

We have audited the accompanying consolidated balance sheets of MatrixOne, Inc. and subsidiaries as of July 2, 2005 and July 3, 2004 and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended July 2, 2005. Our audits also included the financial statement schedule for each of the three years in the period ended July 2, 2005 listed in the Index at Item 15(a). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 financial statements referred to above present fairly, in all material respects, the consolidated financial position of MatrixOne, Inc. and subsidiaries as of July 2, 2005 and July 3, 2004, and the consolidated results of their operations and their cash flows for each of the three years in the period ended July 2, 2005, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of MatrixOne, Inc.'s internal control over financial reporting as of July 2, 2005, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated November 8, 2005 expressed an unqualified opinion on management's assessment and an adverse opinion on the effectiveness of internal control over financial reporting.

As discussed in Note 3 to the accompanying financial statements, the Company has restated its financial statements for the years ended July 3, 2004 and June 28, 2003.

/s/Ernst & Young LLP

Boston, Massachusetts  
November 8, 2005



## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of MatrixOne, Inc.:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that MatrixOne, Inc. did not maintain effective internal control over financial reporting as of July 2, 2005, because of the effect of the three material weaknesses identified in management's assessment, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). MatrixOne, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses have been identified and included in management's assessment:

1. ***Inadequate communication and monitoring of policies and procedures.*** The Company does not have sufficient communication to employees regarding their duties and control responsibilities, and monitoring by management, to ensure adherence by its employees to its code of business conduct and revenue recognition policy; and the Company does not have sufficient communication with its employees, and monitoring by management, to ensure timely notification of actual or perceived violations of its policies and procedures. These are considered to be a deficiency that is also a material weakness in the operation of entity-level controls.

2. ***Inadequate staffing and lack of certain requisite skills and competencies within the finance and accounting organization.*** The Company does not have a sufficient number of experienced personnel in its accounting and finance organization to facilitate the financial statements close process and permit the preparation of its financial statement in accordance with generally accepted accounting principles. The Company's personnel also lacks certain required skills and competencies to oversee the accounting operations and review, periodically inspect and test, and investigate the transactions of its foreign locations and ensure sufficient segregation of duties and financial management. This is considered to be a deficiency that is also a material weakness in the operation of entity-level controls.
3. ***Inadequate process, personnel with requisite skills and competencies, and oversight to identify the full scope of the Company's arrangements with its customers.*** The Company does not have adequate staffing or personnel with requisite skills and competencies, revenue recognition processes, financial systems and controls, and management oversight to reasonably a) ensure the prevention and detection of unauthorized arrangements with customers, b) ensure the prevention and detection of concessions primarily related to maintenance terms and conditions, c) ensure that documentation of vendor specific objective evidence of services was sufficient and d) evaluate the associated accounting implications. The Company does not have a sufficient number of personnel and personnel with the requisite skills and competencies in its accounting and finance organization to provide reasonable assurance that complex multiple element arrangements were being recorded as necessary to facilitate the financial statement close process and permit the preparation of financial statements in accordance with generally accepted accounting principles. As a result, material revenue-related adjustments have been posted to the Company's books and records in its current and prior year financial statements.

These material weaknesses collectively resulted in the Company prematurely recognizing revenue, thereby causing, for any transaction or series of transactions, revenue to be overstated in an earlier period and understated in a later period, deferred revenue to be understated in any particular period, costs and expenses to vary in any particular period and the Company's net loss to be understated in an earlier period and overstated in a later period.

These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2005 financial statements, and this report does not affect our report dated November 8, 2005 on those financial statements.

In our opinion, management's assessment that MatrixOne, Inc. did not maintain effective internal control over financial reporting as of July 2, 2005, is fairly stated, in all material respects, based on the COSO control criteria. Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, MatrixOne, Inc. has not maintained effective internal control over financial reporting as of July 2, 2005, based on the COSO control criteria.

Ernst & Young LLP

Boston, Massachusetts  
November 8, 2005

**MATRIXONE, INC.**

**CONSOLIDATED BALANCE SHEETS**  
(In thousands, except per share amounts)

	<u>July 2, 2005</u>	<u>July 3, 2004</u> (As Restated)
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents .....	\$ 107,677	\$ 118,414
Accounts receivable, less allowance for doubtful accounts of \$747 and \$867 (As Restated) .....	28,620	25,862
Prepaid expenses and other current assets .....	<u>8,822</u>	<u>5,963</u>
Total current assets .....	145,119	150,239
PROPERTY AND EQUIPMENT, NET .....	6,096	7,062
GOODWILL .....	11,929	—
OTHER INTANGIBLE ASSETS, NET .....	7,645	—
OTHER ASSETS .....	<u>2,171</u>	<u>2,077</u>
	<u>\$ 172,960</u>	<u>\$ 159,378</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable .....	\$ 5,941	\$ 3,862
Accrued expenses .....	23,034	14,592
Deferred revenue .....	<u>37,040</u>	<u>31,250</u>
Total current liabilities.....	<u>66,015</u>	<u>49,704</u>
LONG TERM DEFERRED REVENUE .....	5,163	1,728
<b>COMMITMENTS AND CONTINGENCIES (NOTE 9)</b>		
<b>STOCKHOLDERS' EQUITY:</b>		
Preferred stock, \$0.01 par value per share, 5,000 shares authorized, 0 shares issued and outstanding .....	—	—
Common stock, \$0.01 par value per share; 100,000 shares authorized; 51,771 and 48,733 shares issued and outstanding .....	518	487
Additional paid-in capital .....	227,489	213,152
Accumulated deficit.....	(128,088)	(107,767)
Accumulated other comprehensive income.....	<u>1,863</u>	<u>2,074</u>
Total stockholders' equity .....	<u>101,782</u>	<u>107,946</u>
	<u>\$ 172,960</u>	<u>\$ 159,378</u>

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

**MATRIXONE, INC.**

**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In thousands, except per share amounts)

	<b>Year Ended</b>		
	<b>July 2, 2005</b>	<b>July 3, 2004</b>	<b>June 28, 2003</b>
		<b>(As Restated)</b>	<b>(As Restated)</b>
REVENUES:			
Software license.....	\$ 47,300	\$ 38,747	\$ 38,006
Service .....	76,754	70,830	67,015
Total revenues.....	<u>124,054</u>	<u>109,577</u>	<u>105,021</u>
COST OF REVENUES:			
Software license.....	4,287	3,223	3,363
Amortization of purchased technology .....	731	—	—
Service(1).....	49,472	46,218	46,467
Total cost of revenues.....	<u>54,490</u>	<u>49,441</u>	<u>49,830</u>
Gross profit.....	<u>69,564</u>	<u>60,136</u>	<u>55,191</u>
OPERATING EXPENSES:			
Selling and marketing(1) .....	44,638	36,621	41,530
Research and development(1).....	29,080	23,028	26,377
General and administrative(1) .....	16,030	10,256	10,485
Amortization of intangible assets .....	414	—	—
Stock-based compensation(1).....	—	567	3,195
Restructuring charges .....	—	1,751	3,423
Asset impairment and disposal charges .....	—	1,680	—
Total operating expenses .....	<u>90,162</u>	<u>73,903</u>	<u>85,010</u>
Loss from operations .....	<u>(20,598)</u>	<u>(13,767)</u>	<u>(29,819)</u>
OTHER INCOME (EXPENSE):			
Interest income.....	1,962	1,187	1,946
Other income (expense), net .....	(182)	206	(38)
Total other income .....	<u>1,780</u>	<u>1,393</u>	<u>1,908</u>
Loss before income taxes.....	(18,818)	(12,374)	(27,911)
PROVISION FOR INCOME TAXES.....	1,503	32	291
NET LOSS.....	<u>\$ (20,321)</u>	<u>\$ (12,406)</u>	<u>\$ (28,202)</u>
BASIC AND DILUTED NET LOSS PER SHARE:			
Net loss .....	<u>\$ (0.40)</u>	<u>\$ (0.26)</u>	<u>\$ (0.59)</u>
Shares used in computing basic and diluted net loss per share .....	<u>51,238</u>	<u>48,411</u>	<u>47,489</u>

(1) The following summarizes the allocation of stock-based compensation:

Cost of service revenues.....	\$ —	\$ 172	\$ 812
Selling and marketing.....	—	165	868
Research and development .....	—	107	692
General and administrative.....	—	123	823
Total stock-based compensation.....	<u>\$ —</u>	<u>\$ 567</u>	<u>\$ 3,195</u>

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

**MATRIXONE, INC.**

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
(In thousands)

	<u>Common Stock</u>		<u>Additional Paid-in Capital</u>	<u>Deferred Stock-Based Compensation</u>	<u>Accumulated Deficit</u>	<u>Comprehensive Income (Loss)</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total Stockholders' Equity</u>
	<u>Number of Shares</u>	<u>Amount</u>						
BALANCE, JUNE 29, 2002 (as restated) .....	47,030	\$ 470	\$ 210,788	\$ (3,898)	\$ (67,159)	(As Restated)	(As Restated)	(As Restated)
Comprehensive loss:								
Foreign currency translation adjustments.....	—	—	—	—	—	\$ 1,097	1,097	1,097
Net loss.....	—	—	—	—	(28,202)	(28,202)	—	(28,202)
Comprehensive loss .....						<u>\$ (27,105)</u>		
Stock option exercises.....	705	7	455	—	—		—	462
Purchases under employee stock purchase plan .....	469	5	1,174	—	—		—	1,179
Repurchase of common stock .....	(300)	(3)	(1,033)	—	—		—	(1,036)
Stock-based compensation.....	—	—	—	3,195	—		—	3,195
Reversal of stock-based compensation from stock option forfeitures.....	—	—	(136)	136	—		—	—
BALANCE, JUNE 28, 2003 (as restated) .....	47,904	479	211,248	(567)	(95,361)		1,849	117,648
Comprehensive loss:								
Foreign currency translation adjustments.....	—	—	—	—	—	\$ 225	225	225
Net loss.....	—	—	—	—	(12,406)	(12,406)	—	(12,406)
Comprehensive loss .....						<u>\$ (12,181)</u>		
Stock option exercises.....	539	5	976	—	—		—	981
Purchases under employee stock purchase plan .....	290	3	928	—	—		—	931
Stock-based compensation.....	—	—	—	567	—		—	567
BALANCE, JULY 3, 2004 (as restated).....	48,733	487	213,152	—	(107,767)		2,074	107,946
Comprehensive loss:								
Foreign currency translation adjustments.....	—	—	—	—	—	\$ (211)	(211)	(211)
Net loss.....	—	—	—	—	(20,321)	(20,321)	—	(20,321)
Comprehensive loss .....						<u>\$ (20,532)</u>		
Issuance of common stock related to Synchronicity acquisition .	2,304	23	12,200	—	—		—	12,223
Stock option exercises.....	400	4	760	—	—		—	764
Purchases under employee stock purchase plan .....	334	4	1,377	—	—		—	1,381
BALANCE, JULY 2, 2005 .....	<u>51,771</u>	<u>\$ 518</u>	<u>\$ 227,489</u>	<u>\$ —</u>	<u>\$ (128,088)</u>		<u>\$ 1,863</u>	<u>\$ 101,782</u>

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

**MATRIXONE, INC.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(In thousands)**

	<b>Year Ended</b>		
	<b>July 2, 2005</b>	<b>July 3, 2004</b>	<b>June 28, 2003</b>
		<b>(As Restated)</b>	<b>(As Restated)</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net loss	\$ (20,321)	\$ (12,406)	\$ (28,202)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation .....	3,025	4,361	5,244
Amortization of purchased technology and intangible assets.....	1,144	—	—
Asset impairment and disposal charges.....	—	1,680	—
Stock-based compensation .....	—	567	3,195
Provision for doubtful accounts .....	2	32	414
Changes in assets and liabilities:			
Accounts receivable.....	1,074	(4,504)	17,214
Prepaid expenses and other current assets .....	(2,827)	(277)	(629)
Accounts payable.....	1,479	(1,736)	(4,542)
Accrued expenses .....	6,447	(457)	(5,599)
Deferred revenue .....	7,397	1,230	1,085
Net cash used in operating activities .....	<u>(2,580)</u>	<u>(11,510)</u>	<u>(11,820)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchases of property and equipment.....	(1,857)	(1,057)	(2,222)
Other assets.....	44	325	338
Cash paid for business combinations, net of cash acquired of \$790 .....	<u>(6,564)</u>	<u>—</u>	<u>—</u>
Net cash used in investing activities.....	<u>(8,377)</u>	<u>(732)</u>	<u>(1,884)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Payment of line of credit assumed in business combination .....	(1,512)	—	—
Proceeds from stock option exercises.....	764	981	462
Proceeds from purchases of common stock under employee stock purchase plan.....	1,381	931	1,179
Repurchases of common stock .....	<u>—</u>	<u>—</u>	<u>(1,036)</u>
Net cash provided by financing activities.....	<u>633</u>	<u>1,912</u>	<u>605</u>
<b>EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS .....</b>	<b>(413)</b>	<b>1,079</b>	<b>1,122</b>
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS.....</b>	<b>(10,737)</b>	<b>(9,251)</b>	<b>(11,977)</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR .....</b>	<b>118,414</b>	<b>127,665</b>	<b>139,642</b>
<b>CASH AND CASH EQUIVALENTS, END OF YEAR .....</b>	<b><u>\$ 107,677</u></b>	<b><u>\$ 118,414</u></b>	<b><u>\$ 127,665</u></b>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>			
Cash paid for income taxes.....	<u>\$ 397</u>	<u>\$ 234</u>	<u>\$ 378</u>
Issuance of common stock in business combination .....	<u>\$ 12,371</u>	<u>\$ —</u>	<u>\$ —</u>

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

## **MATRIXONE, INC.**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS** **(In thousands, except per share amounts)**

#### **Note 1: Description of the Company and Summary of Significant Accounting Policies**

##### ***Description of the Company***

MatrixOne, Inc. (the "Company") is a provider of collaborative product lifecycle management ("PLM") solutions that enable companies from a broad range of industries to accelerate innovation and time to market and drive efficiencies into the product development processes by allowing for the collaborative development, building and management of their products. The Company licenses its software both directly to end users and through a network of domestic and international distributors. The Company generates its revenues from licensing its software and providing professional services, training and maintenance and customer support services. The Company has its headquarters in the United States ("U.S."), with offices in Canada, England, France, Germany, Italy, Japan, Korea, Singapore, and the Netherlands and throughout the U.S.

##### ***Use of Estimates***

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and judgments, which are evaluated on an on-going basis, that affect the amounts reported in the consolidated financial statements and accompanying notes. Management bases its estimates on historical experience and on various other assumptions that it believes are reasonable at that time under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the amounts of revenues and expenses that are not readily apparent from other sources. Actual results could differ from those estimates. In particular, significant estimates and judgments include those related to revenue recognition, allowance for doubtful accounts, accounting for business combinations and valuation of goodwill and long-lived intangible assets, useful lives of property and equipment, valuation of deferred tax assets and professional services warranty.

##### ***Basis of Presentation and Principles of Consolidation***

The Company operates on a 52 or 53 week fiscal year that ends on the Saturday closest to June 30th and on thirteen or fourteen week fiscal quarters that end on the Saturday closest to September 30th, December 31st and March 31st. The fiscal quarter ended January 3, 2004 consisted of fourteen weeks, and the fiscal year ended July 3, 2004 consisted of 53 weeks. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

##### ***Foreign Currency Translation and Transactions***

The functional currency of each subsidiary is the local currency. Assets and liabilities of foreign subsidiaries are translated at the rates in effect at the balance sheet date, while stockholders' equity is translated at historical rates. Statements of operations transactions are translated at the rate on the date of the transaction or the average rate for the month if transaction specific information is not available. Cash flow amounts are translated at the average rate for the period. Translation adjustments are included as a component of accumulated other comprehensive income. During fiscal 2005, 2004 and 2003, the net effect of realized and unrealized foreign currency transaction gains and (losses) aggregated (\$168), \$256 and \$52, respectively, and were included in other income (expense), net.

## MATRIXONE, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued) (In thousands, except per share amounts)

#### *Derivative Financial Instruments*

The Company's exposure to foreign currency exchange rate fluctuations arises in part from intercompany transactions. The Company's intercompany transactions are typically denominated in the local currency of the foreign subsidiary in order to centralize foreign currency risk at the parent company in the United States. The parent company and its foreign subsidiaries may also transact business in a currency other than the local currency.

The Company's foreign currency hedging program is principally designed to mitigate the future potential impact of changes in the value of transactions denominated in a currency other than the local currency as a result of changes in foreign currency exchange rates, which may impact the Company's results of operations. The Company's foreign currency hedging program is not designed, nor does the Company enter into foreign currency contracts, to mitigate translation risk. No derivative instruments utilized by the Company have been designated as hedging instruments. The Company uses forward contracts to reduce its exposure to foreign currency risk due to fluctuations in exchange rates underlying the value of accounts receivable and accounts payable and intercompany accounts receivable and intercompany accounts payable denominated in a currency other than the local currency. A forward contract obligates the Company to exchange predetermined amounts of specified foreign currencies at specified exchange rates on specified dates. These forward contracts are denominated in the same currency in which the underlying foreign currency receivables or payables are denominated and bear a contract value and maturity date that approximate the value and expected settlement date, respectively, of the underlying transactions. Unrealized gains and losses on open contracts at the end of each accounting period, resulting from changes in the fair value of these contracts, are recognized in earnings in the same period as gains and losses on the underlying foreign denominated receivables or payables are recognized and generally offset. Gains and losses on forward contracts and foreign denominated receivables and payables are included in other income (expense), net. The Company does not enter into or hold derivatives for trading or speculative purposes, and the Company only enters into forward contracts with highly rated financial institutions. At July 2, 2005 and July 3, 2004, there were no open forward contracts.

#### *Comprehensive Income (Loss)*

Comprehensive income (loss) includes net income (loss) as well as other changes in stockholders' equity, except stockholders' investments and distributions, repurchases of common stock and deferred stock-based compensation.

#### *Revenue Recognition*

The Company generates revenues from licensing its software and providing professional services, training and maintenance and customer support services. The Company executes separate contracts that govern the terms and conditions of each software license and maintenance arrangement and each professional services arrangement. These contracts may be considered together as a single multiple-element arrangement. Revenues under multiple-element arrangements, which may include several different software products or services sold together, are allocated to each element using the residual method.



## MATRIXONE, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued) (In thousands, except per share amounts)

The Company uses the residual method when fair value does not exist for one of the delivered elements in an arrangement. Under the residual method, the fair value of the undelivered elements is deferred and subsequently recognized. The Company has established sufficient vendor specific objective evidence of fair value for professional services, training and maintenance and customer support services, except for maintenance and customer support services in Japan (discussed below), based on the price charged when these elements are sold separately. Accordingly, software license revenue is recognized under the residual method in arrangements in which software is licensed with professional services, training or maintenance and customer support services.

The Company has not established sufficient vendor specific objective evidence of fair value for maintenance and customer support services in Japan. Accordingly, the software license fees in Japan are recognized ratably over the term of the related maintenance and customer support services contract, generally one year, on a straight-line basis.

The Company primarily provides the following four types of software license arrangements:

- *Perpetual software license* – the Company recognizes software license revenues from perpetual licenses under the residual method upon execution of a signed software license agreement, delivery of the software to a customer and determination that collection of a fixed or determinable license fee is probable;
- *Two year or more time-based license* – the Company recognizes software license revenues from two year or more time-based licenses under the residual method upon execution of a signed software license agreement, delivery of the software to a customer and determination that collection of a fixed or determinable license fee is probable;
- *Less than two year time-based license* - the Company recognizes software license revenues from less than two year time-based licenses ratably over the period of the license arrangement. Since the Company does not have vendor specific objective evidence of fair value for maintenance and customer support for such arrangements, both the software license and maintenance and customer support fees are included in software license revenues; and
- *Revenue sharing, royalty and subscriber arrangements with and through third-parties* – the Company recognizes revenue sharing, royalty and subscriber arrangements with and through third-parties as software license revenue when they are fixed or determinable, generally upon receipt of a statement from the third-party and determination that collection of the fixed or determinable license fee is probable.

If a customer is provided extended payment terms, revenue is recognized when the fees become due. A software license is considered delivered when the customer receives the physical media in accordance with the applicable shipping terms or is provided access to the electronic software files.

## MATRIXONE, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued) (In thousands, except per share amounts)

In accordance with the Company's agreements with its value-added resellers and distributors ("Alliance Partners"), an Alliance Partner has the right to license the Company's software to its customers ("end users"). Therefore, the Company has no obligation to the Alliance Partner's end users. Accordingly, the Company recognizes software license revenues from an Alliance Partner upon receipt of a written confirmation from the Alliance Partner of an arrangement with the ultimate end user, delivery of the software to the Alliance Partner and when all other revenue recognition criteria, including fulfillment of all obligations and commitments, have been met.

Service revenues include professional services, reimbursements received for out-of-pocket expenses incurred, training and maintenance and customer support fees. Professional services are generally not essential to the functionality of the other elements in an arrangement and are accounted for separately. Professional services revenues are primarily derived from time and material contracts and are recognized as the services are performed. Professional services revenues for fixed-price contracts are recognized using a concept of proportional performance based upon the ratio of direct labor costs incurred to total expected labor costs. If conditions for acceptance are required or the arrangement includes future product deliverables, professional services revenues and related software license revenue are recognized upon customer acceptance or upon delivery of the future deliverables. Customers generally reimburse the Company for the majority of its out-of-pocket expenses incurred during the course of an engagement. The Company does not mark-up or add additional fees to the actual out-of-pocket expenses incurred. Training revenues are recognized as the services are provided.

For arrangements that include the licensing of software and the performance of professional services under a fixed-price contract, both the software license revenues and professional services revenues are recognized using a concept of proportional performance based upon the ratio of direct labor costs incurred to total expected labor costs.

Maintenance and customer support fees include the right to unspecified upgrades on a when-and-if-available basis and ongoing technical support. Maintenance and customer support fees are recognized ratably over the term of the contract, generally one year, on a straight-line basis. When a maintenance and customer support fee is included in a software license fee, a portion of the software license fee is allocated to maintenance and customer support fees based on the renewal rate of maintenance and customer support fees.

#### ***Cash Equivalents***

The Company considers all time deposits and short-term investments with an original maturity of 90 days or less at the date of purchase to be cash equivalents. The Company's cash equivalents are primarily comprised of diversified U.S. and international money market mutual funds, which are reported at cost, and U.S. Treasury and agency securities and commercial paper registered and traded in the U.S., which are reported at amortized cost. The reported value of the Company's cash equivalents approximates market value.

#### ***Fair Value of Financial Instruments***

The Company's financial instruments consist primarily of cash and cash equivalents, accounts receivable and accounts payable. The book values of these financial instruments approximated their respective fair values as of each balance sheet presented due to their short-term maturities.

## **MATRIXONE, INC.**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)** **(In thousands, except per share amounts)**

#### ***Concentrations of Credit Risk***

Financial instruments that potentially subject the Company to concentrations of credit risk are principally cash, cash equivalents and accounts receivable. Concentration of credit risk with respect to cash and cash equivalents is limited because the Company deposits its cash in highly rated financial institutions in North America, Europe and Asia/Pacific and invests in diversified U.S. and international money market mutual funds. The Company only invests in highly rated commercial paper registered and traded in the U.S. and limits its investment in any one issuer to \$5,000 and, therefore, believes credit risk related to its investments in commercial paper is limited. In addition, the Company believes there is no credit risk related to its investments in U.S. Treasury and agency securities. The Company's investments in U.S. Treasury and agency securities and commercial paper have original maturity dates of 90 days or less, which further mitigates the Company's exposure to credit risk.

Concentration of credit risk with respect to accounts receivable is limited to certain customers to whom the Company makes substantial sales. The Company 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.

#### ***Allowance for Doubtful Accounts***

The Company periodically assesses the collectibility of customer accounts receivable. The Company maintains an allowance for estimated losses resulting from uncollectible customer accounts receivable. In estimating this allowance, the Company considers customer specific factors such as historical collection experience, current credit worthiness, the aggregate amount due, age of the receivable and general economic conditions that may affect a customer's ability to pay. The Company also considers factors such as the overall balance and aging of our accounts receivable, as well as customer and geographic concentrations. The allowance for doubtful accounts was \$747 and \$867 at July 2, 2005 and July 3, 2004, respectively.

#### ***Property and Equipment***

Property and equipment are recorded at cost. Internal and external costs incurred to develop, implement and install computer software for internal use are capitalized. Depreciation is computed using the straight-line method over the estimated useful lives of the assets (computer equipment and software, one to five years; furniture and fixtures, three to 10 years; office equipment, three to five years; leasehold improvements, shorter of useful life or remaining lease term). Maintenance and repair expenditures are charged to operations when incurred, and additions and improvements are capitalized. The Company reviews its property and equipment whenever events or changes in circumstances may indicate that the carrying amount of certain assets may not be recoverable and recognizes an impairment loss when it is probable that the estimated cash flows are less than the carrying value of these assets. Property and equipment to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. Net losses on disposals and impairment of property and equipment are included in other income (expense), and are not material to the Company's consolidated financial condition, results of operations or cash flows.

In conjunction with the October 2003 restructuring program (Note 4), the Company evaluated the recoverability of certain of its assets. Based on this evaluation, the Company determined that certain capitalized software would not be recoverable due to the Company's inability to utilize and maintain this software as a result of the termination of certain operational and technical personnel and the reorganization of certain departments.

## MATRIXONE, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued) (In thousands, except per share amounts)

Accordingly, the Company recorded an asset impairment charge of \$1,209, which represented the net book value of this software as of the evaluation date. In addition, in conjunction with the closure and consolidation of certain office facilities, the Company abandoned or disposed of certain office equipment and leasehold improvements that could not be transferred to or used by the remaining offices and recorded an asset abandonment and disposal charge of \$471, which represented the net book value of these assets on the date of the abandonment or disposal.

#### *Goodwill and Other Intangible Assets*

Intangible assets consist of acquired technology, customer contracts and related customer relationships, trademarks and trade names acquired through business combinations and the values allocated to these intangible assets are amortized using the straight-line method over the estimated useful life of the related asset. Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable and an impairment loss is recognized when it is probable that the estimated cash flows are less than the carrying amount of the asset.

Goodwill is not subject to amortization and is tested annually for impairment, or more frequently if events and circumstances indicate that the asset might be impaired. Goodwill is required to be tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis and between annual tests in certain circumstances. The Company evaluates the impairment of goodwill annually in its fourth fiscal quarter with the assistance of an independent valuation firm. Application of the goodwill impairment test requires making judgments about the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value of the reporting units. The Company has determined that it has one reporting segment (refer to Note 12 “Segment and Geographic Information”). Significant judgments required to estimate the fair value of a reporting unit include estimating future cash flows and determining appropriate discount rates. Changes in these judgments, estimates and assumptions could materially affect the determination of fair value for the reporting unit and therefore the determination as to the existence or size of any impairment. Any impairment losses recorded in the future could have a material adverse impact on the Company’s financial condition and results of operations.

Goodwill is tested for impairment using a two-step approach. The first step is to compare the fair value of the reporting unit to its carrying amount, including goodwill. If the fair value of the reporting unit is greater than its carrying amount, goodwill is not considered impaired, but if the fair value of the reporting unit is less than its carrying amount, the amount of the impairment loss, if any, must be measured. An impairment loss is recognized to the extent that the carrying amount of goodwill exceeds its fair value. During the fourth quarter of fiscal 2005, the Company completed its annual impairment analysis of goodwill. Based on the results of this impairment review, the Company has determined that no indicators of impairment existed for fiscal 2005 and, accordingly, no impairment charge was recognized during fiscal 2005.

## **MATRIXONE, INC.**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)** **(In thousands, except per share amounts)**

#### ***Professional Services Warranty***

The Company's professional services are generally warranted to be performed in a workmanlike manner. In the event the customer requests the work be corrected, the Company generally will provide these additional professional services at no charge to comply with its warranty obligations and to ensure customer satisfaction. The Company estimates its professional services warranty liability based on historical activity. Warranty expense is included in cost of services. If the Company's actual warranty activities differ from these estimates, revisions to the estimated warranty liability would be required and result in additional charges to cost of services. The Company primarily satisfies its warranty obligations by providing in-kind services.

#### ***Shipping and Handling Costs***

The Company records shipping and handling costs related to the distribution of its software as cost of software license revenues.

#### ***Research and Development and Software Development Costs***

Research and development costs are charged to expense as incurred. Software development costs are included in research and development and are charged to expense as incurred. After technological feasibility is established, material software development costs are capitalized. The capitalized cost is then amortized on a straight-line basis over the estimated product life, or in the ratio of current revenues to total projected product revenues, whichever is greater. To date, the period between achieving technological feasibility, which the Company has defined as when beta testing commences (which approximates having a working model) and the general availability of such software has been minimal, and software development costs qualifying for capitalization have been insignificant. Accordingly, the Company has not capitalized any software development costs for the periods presented.

#### ***Stock-Based Compensation***

Pursuant to the Company's Third Amended and Restated 1996 Stock Plan (the "1996 Plan") and the Company's Amended and Restated 1999 Stock Plan (the "1999 Plan"), the Company may grant incentive and nonqualified stock options, stock issuances and opportunities to make direct purchases of stock to employees, officers or consultants of the Company. The Company records stock-based compensation issued to employees and directors (collectively "employees") using the intrinsic value method and stock-based compensation issued to non-employees using the fair value method. Stock-based compensation is recognized on stock options issued to employees if the option exercise price is less than the market price of the underlying stock on the date of grant, and stock-based compensation is recognized on all stock options granted to non-employees. During the periods presented, no stock options were issued to employees at an exercise price less than the market price of the underlying stock on the date of grant, and no stock options were issued to non-employees. Accordingly, no deferred stock-based compensation was recorded pursuant to stock options granted during the periods presented.

**MATRIXONE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
**(In thousands, except per share amounts)**

Had compensation expense for all stock options been determined based on fair value as prescribed by Statement of Financial Accounting Standards No. 123, the Company's pro forma net loss and pro forma basic and diluted net loss per share would have been as follows:

	<b>Year Ended</b>		
	<b>July 2, 2005</b>	<b>July 3, 2004</b>	<b>June 28, 2003</b>
		<b>(As Restated)</b>	<b>(As Restated)</b>
<b>NET LOSS:</b>			
Net loss, as reported.....	\$ (20,321)	\$ (12,406)	\$ (28,202)
Exclude:			
Stock-based compensation expense related to stock options included in net loss.....	—	567	3,195
Include: .....			
Stock-based compensation expense related to:			
Company's stock option plan using the fair value method .....	(18,890)	(12,512)	(14,146)
Company's Employee Stock Purchase Plan using the fair value method .....	(525)	(552)	(576)
Pro forma net loss .....	<u>\$ (39,736)</u>	<u>\$ (24,903)</u>	<u>\$ (39,729)</u>
<b>BASIC AND DILUTED NET LOSS PER SHARE:</b>			
As reported .....	\$ (0.40)	\$ (0.26)	\$ (0.59)
Pro forma .....	\$ (0.78)	\$ (0.51)	\$ (0.84)

Beginning in fiscal 2006, the Company will be required to adopt Statement of Financial Accounting Standards No. 123(R) "Share-Based Payments" ("SFAS 123(R)"), which requires all share-based payments to employees, including stock options and stock issued under certain employee stock purchase plans, to be recognized in the Company's financial statements at their fair value. SFAS 123(R) will require the Company to estimate future forfeitures of stock based compensation, while the current pro forma disclosure includes only those options that have been forfeited during the current period. The Company has continued to use the Black-Scholes option pricing model to determine fair value of options under SFAS 123(R) and has elected to use the modified-prospective transition method. Therefore prior period financial statements will not be restated but disclosure of the pro forma net loss calculation will be included in the footnotes to the financial statements for periods prior to fiscal 2006 and the adoption of SFAS 123(R). The Company is currently evaluating its employee stock purchase plan ("ESPP") to determine if changes should be made to minimize compensation charges resulting from the adoption of SFAS 123(R). The impact of adopting SFAS 123(R) cannot be accurately estimated at this time because the calculation depends on the market value and amount of share based awards granted in future periods.

## MATRIXONE, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued) (In thousands, except per share amounts)

On July 1, 2005, the Company accelerated the vesting of substantially all outstanding, unvested “out-of-the-money” options held by employees, officers and directors with exercise prices of at least \$5.75 per share, which was equal to 115% of the \$5.00 closing price of the Company’s common stock on the NASDAQ National Market on June 30, 2005. The vesting of options to purchase approximately 1.8 million shares of common stock with exercise prices ranging from \$5.82 per share to \$19.48 per share, with a weighted average exercise price of \$6.58 per share, were accelerated, including options to purchase approximately 495,000 shares held by executive officers of the Company and options to purchase 15,000 shares held by non-employee directors. The primary purpose of this vesting acceleration is to avoid recognizing stock-based compensation under SFAS 123(R) associated with these “out-of-the-money” options.

Refer to Note 10 “Stockholders’ Equity” for additional information relating to the Company’s stock option plans and the fair value of the Company’s stock options.

#### *Income Taxes*

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

#### *Net Income (Loss) Per Share*

Basic net income (loss) per share is computed by dividing net income (loss) 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) by the shares used in the calculation of basic net income (loss) per share plus the dilutive effect of common stock equivalents, such as stock options, using the treasury stock method. Common stock equivalents are excluded from the computation of diluted net income (loss) per share if their effect is antidilutive.

Potentially dilutive common stock options aggregating 11,803, 10,321 and 7,523 for fiscal 2005, 2004 and 2003, respectively, have been excluded from the computation of diluted net income (loss) per share because their inclusion would be anti-dilutive.

**MATRIXONE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
**(In thousands, except per share amounts)**

**Note 2: Details of Financial Statement Components**

	As of	
	July 2, 2005	July 3, 2004
		(As Restated)
<b>CASH AND CASH EQUIVALENTS:</b>		
Cash .....	\$ 27,670	\$ 11,956
U.S. Treasury and agency securities .....	54,763	59,949
Money market mutual funds .....	25,244	46,509
	<u>\$ 107,677</u>	<u>\$ 118,414</u>
<b>PROPERTY AND EQUIPMENT, NET:</b>		
Computer equipment and software .....	\$ 13,272	\$ 11,961
Furniture and fixtures .....	3,073	2,923
Leasehold improvements .....	4,397	4,300
Office equipment .....	1,289	1,291
	22,031	20,475
Accumulated depreciation .....	<u>(15,935)</u>	<u>(13,413)</u>
	<u>\$ 6,096</u>	<u>\$ 7,062</u>
<b>ACCRUED EXPENSES:</b>		
Compensation .....	\$ 11,906	\$ 9,481
Royalties .....	2,387	1,762
Taxes, primarily compensation related .....	3,078	1,406
Professional services .....	4,599	1,087
Warranty .....	250	300
Other .....	765	464
Restructuring .....	49	92
	<u>\$ 23,034</u>	<u>\$ 14,592</u>

**Note 3: Restatement of Consolidated Financial Statements**

The Company is restating its Consolidated Financial Statements for fiscal 1999 through fiscal 2004 as well as the first two interim periods of fiscal 2005 due to the discovery of errors in revenue recognition related to certain transactions reported by the Company and to address other matters as described below. The following provides a more detailed discussion of the restatement along with a comparison of the amounts previously reported in the Consolidated Balance Sheets and Statements of Operations in the Company's Annual Report on Form 10-K for fiscal 2004 and 2003. The restatement also affects periods prior to fiscal 2003 and these prior amounts have been reflected as an adjustment to the beginning accumulated deficit in fiscal 2003.



## MATRIXONE, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued) (In thousands, except per share amounts)

The Company anticipates filing on the same date as this Annual Report on Form 10-K, its Quarterly Report on Form 10-Q for the fiscal quarter ended April 2, 2005, which will also include restated condensed consolidated financial statements. The Company anticipates filing an amended Quarterly Report on Form 10-Q for the second quarter of fiscal 2005 for the purpose of restating its condensed consolidated financial statements for the second quarter of fiscal 2005. The Company does not anticipate filing amended Annual Reports on Form 10-K or its Quarterly Reports on Form 10-Q for any periods prior to the second quarter of fiscal 2005. Previously filed financial statements for all annual and quarterly periods prior to the third quarter of 2005 should no longer be relied upon.

In the third quarter of fiscal 2005, a new manager at the Company's Japanese subsidiary discovered a side letter, a violation of the Company's policy, which granted a distributor an unauthorized right of return related to certain of the Company's software products. The manager informed the Company's U.S. management about the side letter, who, in turn, notified the Company's independent auditors and the Audit Committee of the Board of Directors. The Audit Committee of the Company's Board of Directors launched a review of the Company's revenue recognition practices ("the review"). As a result of the investigation, the Company identified a pattern of unauthorized arrangements and concessions granted to certain distributors, principally in Japan, in the form of rights of return; exchanges for product which had not been delivered; and timing of commencement of maintenance, among other conditions; as well as a pattern of failure by managers and employees and certain of the Company's distributors to provide accurate information to the Company concerning arrangements included as revenue in the Company's consolidated financial statements. As a result of these findings, the Company determined that the timing of revenue recognition should be deferred until all such concessions and unauthorized arrangements lapse or have been fulfilled. Based on the review, management and the Audit Committee concluded that the failure to detect these unauthorized arrangements and concessions resulted in errors in revenue recognition, which primarily result in the deferral of revenue into later periods than originally recognized, required the Company to restate previously reported financial results. The Company also identified several customer arrangements in prior fiscal periods that included certain commitments to provide future software functionality resulting in the deferral of revenue into later periods when the commitment was or will be fulfilled. The restatement will affect previously reported results from fiscal 1999 through the second quarter of fiscal 2005.

As a result of the restatement, the Company has made adjustments to defer and recognize in different periods revenue associated with certain reseller transactions, including all such transactions in Japan. Certain costs directly associated with these revenues, principally royalties and personnel related costs including commissions, had been previously recognized as an expense in the period in which the associated revenue was recognized and such costs have also been adjusted. These costs are being recognized in the period in which the related software license or professional services revenue is recognized.

As part of the restatement, the Company re-evaluated payments pursuant to certain third party development and licensing arrangements and concluded they should be accounted for as research and development expenses when paid rather than capitalized and amortized to cost of software license revenues based on the greater of the actual royalties incurred to date or the straight-line method of amortization over the estimated useful life.

The Company has restated its financial statements for all periods beginning in fiscal 1999 through the second quarter ended January 1, 2005. The foregoing restatement adjustments did not affect the Company's reported cash and cash equivalents balance during these reported periods.

**MATRIXONE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued)**  
**(In thousands, except per share amounts)**

**Revenue and Expense Adjustments**

Set forth below are the adjustments to the Company's previously issued statements of operations for the fiscal years ended July 3, 2004, and June 28, 2003, and accumulated deficit as of June 29, 2002.

*Accumulated Deficit and Net Loss*

	<b>Net Loss Years Ended</b>		<b>Accumulated Deficit As of</b>
	<b>July 3, 2004</b>	<b>June 28, 2003</b>	<b>June 29, 2002</b>
As previously reported .....	\$ (16,209)	\$ (24,480)	\$ (58,685)
Restatement adjustments, net:			
Software license revenues .....	764	(3,073)	(8,974)
Service revenues .....	(270)	(1,314)	263
Cost of software license revenue.....	3,067	2,059	2,700
Cost of service revenues .....	542	72	758
Operating expenses .....	(444)	(1,302)	(3,732)
Other Income.....	(6)	(14)	86
Provision for income taxes.....	150	(150)	(100)
Discontinued operations.....	—	—	525
Total restatement adjustments.....	<u>3,803</u>	<u>(3,722)</u>	<u>(8,474)</u>
As restated.....	<u>\$ (12,406)</u>	<u>\$ (28,202)</u>	<u>\$ (67,159)</u>

*Software License Revenue*

	<b>July 3, 2004</b>	<b>June 28, 2003</b>
Software license revenues, as previously reported .....	\$ 37,983	\$ 41,079
Software license revenues restatement adjustments, net...	<u>764</u>	<u>(3,073)</u>
Software license revenues, as restated .....	<u>\$ 38,747</u>	<u>\$ 38,006</u>

The Company's policy for recognizing software license revenue from Alliance Partners results in the recognition of software license revenue upon receipt of a written confirmation from the Alliance Partner of an arrangement with the ultimate end user, delivery of the software to the Alliance Partner and when all other revenue recognition criteria are met (refer to Note 1 "Description of the Company and Summary of Significant Accounting Policies"). As a result of the investigation, the Company identified a pattern of unauthorized arrangements and concessions granted to certain distributors, principally in Japan, in the form of rights of return; exchanges for product which had not been delivered; and timing of commencement of maintenance, among other conditions; as well as a pattern of failure by managers and employees and certain of the Company's distributors to provide accurate information to the Company concerning arrangements included as revenue in the Company's consolidated financial statements. As a result of these findings, the Company determined that the timing of revenue recognition should be deferred until all such concessions and unauthorized arrangements have lapsed or have been fulfilled.

## MATRIXONE, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued) (In thousands, except per share amounts)

Further, as a result of the investigation, the Company determined that, because of unauthorized maintenance terms being granted to certain distributors in Japan, the Company is unable to assert that it has vendor specific objective evidence (“VSOE”) for the software license revenue transactions reported by its Japanese subsidiary. Consequently, all license transactions reported by the Company’s Japanese subsidiary during the restatement period are being restated to recognize software license revenue on a straight-line basis over the related maintenance term (primarily one year), beginning generally when maintenance commenced or, if later, when concessions or unauthorized arrangements were fulfilled or subsequently lapsed.

In addition, the Company identified several customer arrangements in prior fiscal periods that included certain commitments to provide future software functionality resulting in the deferral of software license revenue into later periods when the commitment was or will be fulfilled.

#### *Service Revenue*

Service revenues include consulting services, maintenance and customer support services, and training. A number of the Company’s revenue transactions involve multiple elements, including software licenses and maintenance and customer support services. Statement of Position (“SOP”) 97-2, *Software Revenue Recognition*, requires maintenance and customer support service revenues to be recognized over the period such services are provided. Based on the Company’s investigation, the Company identified certain circumstances in which it offered maintenance and customer support services at discounted rates to certain customers but did not properly allocate the fair value for the maintenance and customer support service from software license revenue. This resulted in revenue associated with the value of the maintenance and customer support services not being recognized in the proper amount over the service period. In the restated financial statements, the Company has recognized maintenance and customer support service revenue ratably over the period in which the maintenance and customer support service was provided based on the deferral of the applicable VSOE of maintenance and customer support service. In such cases, the Company has reclassified maintenance and customer support service from software license revenue to service revenues for the applicable periods presented. The Company also identified several customer arrangements in prior fiscal periods that included certain commitments to provide future software functionality resulting in the deferral of professional service and maintenance and customer support revenues into later periods when the commitment was or will be fulfilled.

Other service revenue adjustments relate to certain service revenue allowances which were previously identified and determined to be immaterial to the Company’s consolidated financial statements. Adjustments related to these allowances were reversed during fiscal 2004 and fiscal 2003, decreasing service revenue in those years. These adjustments related to service revenue allowances established prior to fiscal 2002 for potential service revenue recognition matters with respect to certain professional service arrangements.

#### *Cost of Software License Revenues*

Cost of software licenses primarily consists of royalties paid to third-parties for certain products licensed to the Company’s customers. As a result of the restatement, certain software license revenues were adjusted as described in above. Accordingly, certain direct costs related to software license revenues were deferred to reflect the associated deferred recognition of these revenues. These costs are being recognized in the period in which the related software license revenue is recognized.

## MATRIXONE, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued)

#### (In thousands, except per share amounts)

As part of the restatement, the Company re-evaluated payments pursuant to certain third party development and licensing arrangements and concluded they should be accounted for as research and development expenses when paid rather than capitalized and amortized to cost of software license revenues based on the greater of the actual royalties incurred to date or the straight-line method of amortization over the estimated useful life.

#### *Cost of Service Revenues*

As a result of the restatement, certain professional service and maintenance and customer support revenues were adjusted as previously described. Accordingly, the direct costs related to professional service revenues were deferred to reflect the deferred recognition of these revenues. These costs are being recognized in the period in which the related revenues are recognized.

The Company records an estimate of professional services warranty based on historical activity. Estimated professional services warranty costs are included in cost of service revenues. The Company primarily satisfies its warranty obligations by providing in-kind services. Over the past several years, the Company has had favorable professional services warranty experience. As part of the restatement, the Company has adjusted its professional services warranty to reflect its actual historical experience.

#### *Operating Expenses*

Operating expenses include selling and marketing, research and development and general and administrative. As part of the restatement, the Company deferred certain direct selling expenses related to deferred software license revenue. These expenses will be recognized in the period in which the related software license revenue is recognized. The Company also reclassified certain prepaid software royalty fees related third-party development arrangements from prepaid expenses and other current assets to research and development expense. In addition, the Company has adjusted its allowance for doubtful accounts, which is included in general and administrative expenses, to reflect its actual historical experience. Consequently, the financial statement schedule listed in Schedule II contained herein has been restated. Finally, the Company has also recorded certain adjustments for previously unrecorded immaterial errors related to certain operating expense estimates and accruals.

# MATRIXONE, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued) (In thousands, except per share amounts)

### Impact of the Financial Statement Adjustments on the Consolidated Statements of Operations

The following table presents the impact of the financial statement adjustments on the Company's previously reported consolidated statements of operations for the fiscal years ended July 3, 2004 and June 28, 2003:

	Year Ended			
	July 3, 2004 (As Reported)	July 3, 2004 (As Restated)	June 28, 2003 (As Reported)	June 28, 2003 (As Restated)
<b>Consolidated Statements of Operations Data:</b>				
Revenues:				
Software license .....	\$ 37,983	\$ 38,747	\$ 41,079	\$ 38,006
Service.....	<u>71,100</u>	<u>70,830</u>	<u>68,329</u>	<u>67,015</u>
Total revenues.....	<u>109,083</u>	<u>109,577</u>	<u>109,408</u>	<u>105,021</u>
Cost of revenues:				
Software license .....	6,290	3,223	5,422	3,363
Service.....	<u>46,760</u>	<u>46,218</u>	<u>46,539</u>	<u>46,467</u>
Total cost of revenues.....	<u>53,050</u>	<u>49,441</u>	<u>51,961</u>	<u>49,830</u>
Gross profit .....	<u>56,033</u>	<u>60,136</u>	<u>57,447</u>	<u>55,191</u>
Operating expenses:				
Selling and marketing .....	36,951	36,621	41,589	41,530
Research and development.....	22,889	23,028	25,049	26,377
General and administrative .....	9,621	10,256	10,452	10,485
Stock-based compensation.....	567	567	3,195	3,195
Restructuring charges.....	1,751	1,751	3,423	3,423
Asset impairment and disposal charges .....	<u>1,680</u>	<u>1,680</u>	<u>—</u>	<u>—</u>
Total operating expenses .....	<u>73,459</u>	<u>73,903</u>	<u>83,708</u>	<u>85,010</u>
Loss from operations .....	(17,426)	(13,767)	(26,261)	(29,819)
Other income, net .....	1,399	1,393	1,922	1,908
Provision for income taxes .....	<u>182</u>	<u>32</u>	<u>141</u>	<u>291</u>
Net loss .....	<u>\$ (16,209)</u>	<u>\$ (12,406)</u>	<u>\$ (24,480)</u>	<u>\$ (28,202)</u>
<b>Basic net loss per share:</b>				
Net loss.....	<u>\$ (0.33)</u>	<u>\$ (0.26)</u>	<u>\$ (0.52)</u>	<u>\$ (0.59)</u>
Shares used in computation.....	<u>48,411</u>	<u>48,411</u>	<u>47,489</u>	<u>47,489</u>
<b>Diluted net loss per share:</b>				
Net loss.....	<u>\$ (0.33)</u>	<u>\$ (0.26)</u>	<u>\$ (0.52)</u>	<u>\$ (0.59)</u>
Shares used in computation.....	<u>48,411</u>	<u>48,411</u>	<u>47,489</u>	<u>47,489</u>

**MATRIXONE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued)**  
**(In thousands, except per share amounts)**

**Impact of the Financial Statement Adjustments on the Consolidated Balance Sheets**

The following is a summary of the impact of the adjustments on the Company's previously reported consolidated balance sheet as of July 3, 2004.

	<b>July 3, 2004</b>	<b>July 3, 2004</b>
	<b>As Reported</b>	<b>As Restated</b>
<b><i>ASSETS</i></b>		
<b>Current Assets:</b>		
Cash and cash equivalents .....	\$ 118,414	\$ 118,414
Accounts receivable, net .....	25,274	25,862
Prepaid expenses and other current assets .....	<u>4,326</u>	<u>5,963</u>
Total current assets .....	148,014	150,239
<b>Property and Equipment, Net</b> .....	7,053	7,062
<b>Other Assets</b> .....	<u>2,078</u>	<u>2,077</u>
	<u>\$ 157,145</u>	<u>\$ 159,378</u>
<b><i>LIABILITIES AND STOCKHOLDERS' EQUITY</i></b>		
<b>Current Liabilities:</b>		
Accounts payable .....	\$ 4,561	\$ 3,862
Accrued expenses .....	15,666	14,592
Deferred revenue .....	<u>20,039</u>	<u>31,250</u>
Total current liabilities .....	<u>40,266</u>	<u>49,704</u>
<b>Long Term Deferred Revenue</b> .....	—	1,728
<b>Stockholders' Equity:</b>		
Common stock .....	487	487
Additional paid-in capital .....	213,152	213,152
Accumulated deficit .....	(99,374)	(107,767)
Accumulated other comprehensive income .....	<u>2,614</u>	<u>2,074</u>
Total stockholders' equity .....	<u>116,879</u>	<u>107,946</u>
	<u>\$ 157,145</u>	<u>\$ 159,378</u>

The restatement also affects periods prior to fiscal 2003 and these prior amounts have been reflected in an adjustment to the beginning accumulated deficit in fiscal 2003.

**MATRIXONE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued)**  
**(In thousands, except per share amounts)**

**Note 4. Restructuring Charges**

***October 2003 Restructuring Program***

As a result of disappointing financial results for the three months ended September 27, 2003 and continued weakness in information technology spending and global economic conditions and the related impact on our business, in October 2003 we implemented a restructuring program to reduce expenses to align our operations and cost structure with current and projected market conditions (the “October 2003 restructuring program”). This restructuring program primarily included a reduction in the number of employees across all functions and locations and the closure and consolidation of certain offices.

The October 2003 restructuring program included a reduction in workforce of 45 employees, consisting of 10 employees in cost of service revenues, 16 employees in selling and marketing, 13 employees in research and development and six employees in general and administration. The costs related to the reduction in workforce include severance, fringe benefits and other related costs. These severed employees were not required to render service in order to receive termination benefits and were not required to render service beyond the minimum retention period.

The October 2003 restructuring program also included costs related to the closure and consolidation of certain office facilities. During the three months ended January 3, 2004, we vacated these offices and entered into agreements with the lessors to terminate the leases before the original lease term and paid a lease termination fee. In conjunction with the consolidation of certain offices, we also incurred certain costs to relocate employees and office furniture and equipment.

The significant components of the October 2003 restructuring program and the related restructuring charges, non-cash adjustments, cash payments and the remaining accrual as of July 3, 2004 were as follows:

	<b>Employee Severance and Fringe Benefits</b>	<b>Facilities and Other Associated Costs</b>	<b>Total</b>
Restructuring charges – fiscal 2004 .....	\$ 1,304	\$ 508	\$ 1,812
Non-cash adjustments – fiscal 2004.....	<u>(99)</u>	<u>(15)</u>	<u>(114)</u>
Adjusted restructuring charges.....	1,205	493	1,698
Cash payments – fiscal 2004.....	<u>(1,205)</u>	<u>(493)</u>	<u>(1,698)</u>
Accrual balance as of July 3, 2004 .....	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

## MATRIXONE, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued) (In thousands, except per share amounts)

#### *April 2003 Restructuring Program*

In April 2003, we reorganized certain of our operations to reduce expenses and to better align our management structure with our strategic initiatives (the “April 2003 restructuring program”). The April 2003 restructuring program consisted of the elimination of certain positions within the Company, primarily at the Vice President and Director level.

The April 2003 restructuring program included a reduction in workforce of 13 employees, consisting of seven employees in selling and marketing, four employees in research and development and two employees in general and administration. The costs related to the reduction in workforce include severance, fringe benefits and other related costs.

The significant components of the April 2003 restructuring program and the related restructuring charges, non-cash adjustments, cash payments and the remaining accrual as of July 2, 2005 were as follows:

	<b><u>Employee Severance and Fringe Benefits</u></b>
Restructuring charge – fiscal 2003.....	\$ 521
Cash payments – fiscal 2003.....	<u>(265)</u>
Accrual balance as of June 28, 2003.....	256
Cash payments – fiscal 2004.....	(259)
Non-cash adjustments – fiscal 2004.....	<u>95</u>
Accrual balance as of July 3, 2004 .....	92
Cash payments – fiscal 2005.....	<u>(43)</u>
Accrual balance as of July 2, 2005 .....	<u>\$ 49</u>

The non-cash adjustments during fiscal 2004 reflect additional employee severance related costs. The April 2003 restructuring program was substantially completed during fiscal 2004. The remaining cash payments are estimated to be made upon settlement of a dispute with an employee terminated pursuant to the plan.

#### *October 2002 Restructuring Program*

As a result of continued weakness in information technology spending and global economic conditions and the related impact on our business, in October 2002 we implemented a restructuring program to reduce expenses to align our operations and cost structure with market conditions (the “October 2002 restructuring program”). This restructuring program primarily included a reduction in the number of employees across all functions and locations, a reduction in the use of independent contractors across all functions and locations and the closure of excess facilities.

The October 2002 restructuring program included a reduction in workforce of 86 employees, consisting of 32 employees in cost of service revenues, 28 employees in selling and marketing, 17 employees in research and development and nine employees in general and administration. The costs related to the reduction in workforce include severance, fringe benefits and other related costs.



**MATRIXONE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
**(In thousands, except per share amounts)**

The October 2002 restructuring program also included facility and lease costs related to the closure of certain excess facilities that we have exited and the termination of certain automotive lease contracts.

The significant components of the October 2002 restructuring program and the related charges, non-cash adjustments, cash payments and the remaining accrual as of July 3, 2004 were as follows:

	<b>Employee Severance and Fringe Benefits</b>	<b>Facilities and Leases</b>	<b>Total</b>
Restructuring charges – fiscal 2003 .....	\$ 3,348	\$ 452	\$ 3,800
Non-cash adjustments – fiscal 2003.....	(520)	(135)	(655)
Adjusted restructuring charges – fiscal 2003 .....	2,828	317	3,145
Cash payments – fiscal 2003.....	(2,464)	(198)	(2,662)
Accrual balance as of June 28, 2003.....	364	119	483
Cash payments – fiscal 2004.....	(384)	(57)	(441)
Non-cash adjustments – fiscal 2004.....	20	(62)	(42)
Accrual balance as of July 3, 2004 .....	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

The non-cash adjustments during fiscal 2004 reflect an unfavorable final settlement for an employee severance arrangement and favorable final settlement for certain lease arrangements.

**Note 5: Business Combinations**

On August 4, 2004, the Company acquired Synchronicity Software, Inc. (“Synchronicity”), a provider of electronic design management, team collaboration and intellectual property reuse solutions for the global electronics industry for cash consideration of approximately \$4,529 and the issuance of approximately 2,304 shares of MatrixOne common stock. The acquisition of Synchronicity will add new solutions for semiconductor and electronics design management to the solutions portfolio of the Company, expand the Company’s customer base and deepen the Company’s domain expertise in the electronics industry. The transaction was accounted for under the purchase method of accounting. Accordingly, the results of operations of the acquired entity are included in the Company’s consolidated statements of operations for all periods subsequent to the acquisition date.

The total purchase price for Synchronicity was as follows:

Value of 2,304 shares of MatrixOne common stock issued, net of issuance costs of \$148 .....	\$ 12,223
Cash paid to and on behalf of former Synchronicity security holders...	4,529
Direct transaction costs .....	884
Total purchase price .....	<u>\$ 17,636</u>

# MATRIXONE, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued) (In thousands, except per share amounts)

The purchase price was fixed and there was no contingent consideration. The value of MatrixOne shares issued was \$5.37 per share, based on an average of the closing prices of MatrixOne's common stock on the Nasdaq National Market for the two days up to, after and including the measurement date of July 15, 2004. The direct transaction costs represent the expenses incurred by MatrixOne directly related to the Synchronicity acquisition.

The total purchase price, as shown in the preceding table, is allocated to the tangible and identifiable intangible assets and liabilities of Synchronicity assumed based on their fair values as of the date of the acquisition. The following table presents the fair value of the assets acquired and liabilities assumed:

Current assets .....	\$ 4,202
Property and equipment, net .....	198
Other long term assets.....	74
Current liabilities .....	(2,490)
Deferred revenues .....	<u>(2,193)</u>
Net liabilities assumed .....	(209)
Fair value of acquired lease .....	75
Intangible assets acquired:	
Developed technology .....	4,730
Customer contracts and related customer relationships.....	3,600
Trademarks and trade names .....	250
Goodwill .....	10,117
Accrued acquisition liabilities.....	(761)
Accrued registration costs.....	<u>(166)</u>
Total purchase price .....	<u>\$ 17,636</u>

The Company performed a review to determine whether all tangible assets and liabilities were recorded in Synchronicity's general ledger in accordance with U.S. GAAP. Management of the Company believes that the historical value of the acquired tangible assets and liabilities approximates their respective fair values.

The fair value of intangible assets was estimated by the Company with the assistance of an independent appraisal firm, from which the Company has received a valuation report, involved the following steps:

- Preparation of discounted cash flow analysis;
- Estimation of the fair value of tangible assets;
- Determination of the fair value and estimated useful lives of identified material intangible assets;
- Determination of the fair value and estimated useful lives of developed technology and in-process research and development using a cash flow allocation model;
- Allocation of the residual purchase price to other intangible assets generally in the nature of goodwill; and
- Reconciliation of the individual asset returns with the weighted average cost of capital.

## MATRIXONE, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued) (In thousands, except per share amounts)

An after-tax discount rate of 18%, based on Synchronicity's weighted average cost of capital, was utilized to discount the net cash flows of developed technology, customer contracts and related customer relationships and trademarks and trade names to their present value. The weighted average cost of capital reflected the anticipated market acceptance and penetration of Synchronicity's products, market growth rates and risks related to potential changes in future target markets.

Developed technology represents products that have reached technological feasibility and thus are capitalizable and consist of the existing Synchronicity product lines. Developed technology includes processes and trade secrets developed through years of experience in design and development of Synchronicity's products. The value assigned to developed technology was determined by discounting the estimated future cash flows to be generated from Synchronicity's existing products to their present value. The estimates of revenue used to value the developed technology were based on estimates of relevant market sizes and growth factors, expected trends in technology, and the nature and expected timing of new product introductions by Synchronicity, the combined Company and its competitors.

Customer contracts and related customer relationships represent the value assigned to Synchronicity's installed base of customers based on various assumptions such as probability of additional revenue transactions with these existing customers and the percentage retention of these customers. The installed base of customers represents a significant part of Synchronicity's business as Synchronicity had contract renewal rates of approximately 90% for existing customers. In addition, Synchronicity has consulting and training engagements with numerous customers.

The value of the trademarks and trade names was determined based on estimates of the expected royalties to be earned over the estimated life of the trademarks and trade names.

Goodwill represents the excess of the purchase price for Synchronicity over the fair value of the underlying net tangible and identifiable intangible assets. Of the total purchase price, \$10,117 was allocated to goodwill. Goodwill resulting from business combinations completed subsequent to June 30, 2001 is not amortized but instead is reviewed annually for impairment or more frequently if impairment indicators arise. In the event that management determines that goodwill has become impaired, the combined Company will incur an accounting charge for the amount of the impairment during the fiscal quarter in which the determination is made.

On the date of the acquisition, the combined Company committed to a plan to exit certain activities of Synchronicity at a cost of approximately \$806 in the aggregate, which was included in the purchase price allocation as acquisition liabilities. These acquisition liabilities relate to certain severance and other employee benefits related to the planned termination of ten Synchronicity employees at a cost of approximately \$641, and the cost of vacating a Synchronicity facility of approximately \$165. The Company expects to pay severance and other related benefits and the lease termination costs through September 2005. Should the estimates of these acquisition liabilities change within the purchase price allocation period, there will be a resulting change to the balance of goodwill.

**MATRIXONE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued)**  
**(In thousands, except per share amounts)**

The significant components of the exit plan, cash payments and remaining accrual as of July 2, 2005 were as follows:

	<b>Employee Severance and Fringe Benefits</b>	<b>Facilities and Other Associated Costs</b>	<b>Total</b>
Exit plan costs .....	\$ 641	\$ 165	\$ 806
Non-cash adjustment.....	(29)	(16)	(45)
Cash payments .....	(491)	(149)	(640)
Accrual balance as of July 2, 2005 .....	<u>\$ 121</u>	<u>\$ —</u>	<u>\$ 121</u>

The non-cash adjustment of \$29 represents the reversal of certain severance and other employee benefits related to the retention of two employees previously planned to be terminated. The non-cash adjustment of \$16 represents an adjustment to the estimated costs incurred in vacating the Synchronicity facility.

The following unaudited pro forma financial information presents the combined results of the Company and Synchronicity as if the Synchronicity acquisition had taken place on June 29, 2003. The pro forma amounts give effect to certain adjustments, including the amortization of intangible assets, increased commission expense, decreased interest income, incremental rent expense and certain one-time adjustments which had been recorded by Synchronicity in its historical financial statements. This pro forma information does not necessarily reflect the results of operations as they would have been if the business had been managed by the Company during these periods and is not indicative of results that may be obtained in the future.

	<b>July 2, 2005</b>	<b>July 3, 2004 (As Restated)</b>
Pro forma total revenues .....	\$ 125,216	\$ 122,737
Pro forma net loss .....	\$ (21,065)	\$ (17,867)
Pro forma basic and diluted net loss per share.....	\$ (0.41)	\$ (0.35)

On November 12, 2004 the Company acquired certain intangible assets of Centor Software Corporation (“Centor”), a provider of software for documenting and validating regulatory compliance with the European Union directives that target banned substances and recycling for the automotive and electronics industries, for cash consideration of \$1,750 (the “Centor acquisition”). The acquired intangible assets include certain existing technology, customer contracts and related customer relationships and technology agreements, and all trademarks and trade names. The Centor acquisition added new solutions for regulatory compliance to the solutions portfolio of the Company and expanded the Company’s customer base. The transaction was accounted for as a business combination using the purchase method of accounting and, accordingly, the results of operations of Centor are included in the Company’s consolidated statements of operations for all periods subsequent to the acquisition date.

**MATRIXONE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued)**  
**(In thousands, except per share amounts)**

The total purchase price for the Centor acquisition was as follows:

Cash paid to Centor.....	\$ 1,750
Direct transaction costs .....	<u>199</u>
Total purchase price .....	<u>\$ 1,949</u>

The purchase price was fixed and there was no contingent consideration. The direct transaction costs represent the estimated expenses incurred by MatrixOne directly related to the Centor acquisition.

The following table presents the fair value of the assets acquired and liabilities assumed:

Deferred revenues .....	\$ (73)
Customer contracts and related customer relationships .....	210
Goodwill .....	<u>1,812</u>
Total purchase price .....	<u>\$ 1,949</u>

The estimation of the fair value of intangible assets determined by the Company with the assistance of an independent appraisal firm, from which the Company has received a valuation report, involved the following steps:

- Preparation of discounted cash flow analysis;
- Estimation of the fair value of tangible assets;
- Determination of the fair value and estimated useful lives of identified material intangible assets;
- Determination of the fair value and estimated useful lives of developed technology and in-process research and development using a cash flow allocation model;
- Allocation of the residual purchase price to other intangible assets generally in the nature of goodwill; and
- Reconciliation of the individual asset returns with the weighted average cost of capital.

An after-tax discount rate of 18%, based on Centor's weighted average cost of capital, was utilized to discount the net cash flows of customer contracts and related customer relationships to its present value. The weighted average cost of capital reflected the anticipated market acceptance and penetration of Centor's products, market growth rates and risks related to potential changes in future target markets. Customer contracts and related customer relationships represent the value assigned to Centor's installed base of customers based on various assumptions such as probability of additional revenue transactions with these existing customers and the percentage retention of these customers.

**MATRIXONE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued)**  
**(In thousands, except per share amounts)**

The operations of Centor are not material to those of the Company, and accordingly the Company has not provided unaudited pro forma financial information presenting the combined results of Centor and the Company.

**Note 6. Goodwill and Other Intangible Assets, Net**

Other intangible assets, net were comprised of the following as of July 2, 2005:

Identified Intangible Asset	Useful Life in Years	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Developed technology				
Core technology .....	7	\$ 3,780	\$ (495)	\$ 3,285
Application technology – DesignSync .....	4	710	(163)	547
Application technology – ProjectSync .....	3	<u>240</u>	<u>(73)</u>	<u>167</u>
Total developed technology .....		<u>4,730</u>	<u>(731)</u>	<u>3,999</u>
Customer contracts and related customer relationships - Synchronicity .....	10	3,600	(330)	3,270
Customer contracts and related customer relationships - Centor .....	5	210	(26)	184
Trademarks and trade names .....	4	<u>250</u>	<u>(58)</u>	<u>192</u>
		<u>4,060</u>	<u>(414)</u>	<u>3,646</u>
Total .....		<u>\$ 8,790</u>	<u>\$ (1,145)</u>	<u>\$ 7,645</u>

For fiscal 2005, amortization expense related to identified intangible assets was \$1,145 of which \$731 was related to developed technology and included in cost of revenues and \$414 was related to customer contracts and related customer relationships and trademarks and trade names and included in operating expenses.

The following is the estimated future amortization expense related to other intangible assets as of July 2, 2005:

<b>Fiscal Year</b>	
2006 .....	\$ 1,262
2007 .....	1,262
2008 .....	1,188
2009 .....	962
2010 .....	916
Thereafter .....	<u>2,055</u>
Total .....	<u>\$ 7,645</u>

The following sets forth changes to goodwill for the year ended July 2, 2005:

Goodwill resulting from Synchronicity acquisition .....	\$ 10,117
Goodwill resulting from Centor acquisition .....	<u>1,812</u>
Goodwill balance as of July 2, 2005 .....	<u>\$ 11,929</u>

**MATRIXONE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued)**  
**(In thousands, except per share amounts)**

**Note 7: Professional Services Warranty**

The Company records an estimate of professional services warranty based on historical activity. Warranty expense is included in cost of services and the related liability is included in accrued liabilities. The Company primarily satisfies its warranty obligations by providing in-kind services. The activity related to the Company's warranty accrual is presented below.

	<u>July 2, 2005</u>	<u>July 3, 2004</u>
		<b>(As Restated)</b>
Beginning accrual balance .....	\$ 300	\$ 500
Net provisions for warranty charged to cost of services ..	975	932
Payments made (in kind or in cash) .....	<u>(1,025)</u>	<u>(1,132)</u>
Ending accrual balance .....	<u>\$ 250</u>	<u>\$ 300</u>

**Note 8: Income Taxes**

The following is the geographic pretax loss:

	<b>Year Ended</b>		
	<u>July 2, 2005</u>	<u>July 3, 2004</u>	<u>June 28, 2003</u>
		<b>(As Restated)</b>	<b>(As Restated)</b>
United States .....	\$ (13,366)	\$ (7,429)	\$ (17,002)
Foreign .....	<u>(5,452)</u>	<u>(4,945)</u>	<u>(10,909)</u>
	<u>\$ (18,818)</u>	<u>\$ (12,374)</u>	<u>\$ (27,911)</u>

During fiscal 2005, the Company recorded a provision for income taxes of \$1,503 consisting of an estimated foreign tax audit settlement of \$600, a deferred tax liability of \$279 related to amortization of goodwill for tax purposes related to our acquisitions and current U.S. federal, state and foreign taxes. During fiscal 2004 and 2003, the Company recorded provisions for income taxes of \$32 and \$291, respectively, primarily consisting of current U.S. federal, state and foreign taxes.

At July 2, 2005, the Company had available U.S. federal and state net operating loss ("NOL") carryforwards and tax credits of approximately \$153,868 and \$274, respectively, to reduce future U.S. income taxes. These NOLs include deductions of approximately \$8,499 related to certain stock option exercises. The tax benefit from the NOLs related to the exercise of stock options that exceed the tax benefits related to the amounts recorded as compensation expense will be recorded as an increase to additional paid in capital as these NOLs are utilized. These U.S. federal and state NOLs and tax credit carryforwards expire in varying amounts commencing in fiscal 2006 through fiscal 2025, if not utilized. Use of these NOLs and tax credits may be limited due to certain changes in ownership.

**MATRIXONE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued)**  
**(In thousands, except per share amounts)**

At July 2, 2005, the Company also had NOL carryforwards in certain foreign countries aggregating approximately \$41,512 that are also subject to certain limitations. These NOLs include deductions of approximately \$5,395 related to certain stock option exercises. The tax benefit from the NOLs related to the exercise of stock options will be recorded as an increase to additional paid in capital as these NOLs are utilized. These NOLs expire in varying amounts commencing in fiscal 2006, if not utilized.

The Company's foreign subsidiary undistributed earnings was \$0 at July 2, 2005 and \$700 at July 3, 2004. The Company does not provide U.S. taxes on its foreign subsidiaries' undistributed earnings.

The Company has recorded a valuation allowance against its net deferred tax assets due to the fact it is more likely than not that these net deferred tax assets will not be realized. Management regularly evaluates the realizability of its net deferred tax assets and may adjust the valuation allowance based on such analysis.

The components of the net deferred tax asset are as follows:

	<b>As of</b>	
	<b>July 2, 2005</b>	<b>July 3, 2004</b>
		<b>(As Restated)</b>
Deferred Tax Assets		
Net operating loss carryforwards .....	\$ 52,586	\$ 50,399
Deferred revenue .....	7,317	4,965
Accrued liabilities .....	948	504
Allowance for doubtful accounts .....	236	295
Depreciation .....	834	1,602
Stock compensation .....	156	251
Tax credits .....	274	274
Total deferred tax assets .....	62,351	58,290
Deferred Tax Liability		
Goodwill .....	(279)	—
Prepaid .....	(889)	(404)
Other .....	(478)	(421)
Total deferred tax liability .....	(1,646)	(825)
Valuation allowance .....	(60,984)	(57,465)
Net deferred tax asset .....	<u>\$ (279)</u>	<u>\$ —</u>



**MATRIXONE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued)**  
**(In thousands, except per share amounts)**

The reconciliation between the statutory federal income tax rate and the Company's effective tax rate is as follows:

	<b>July 2, 2005</b>	<b>July 3, 2004 (As Restated)</b>	<b>June 28, 2003 (As Restated)</b>
U.S. federal statutory rate .....	(35.0)%	(35.0)%	(35.0)%
State tax, net of federal tax benefit .....	(2.6)	(2.6)	(1.1)
Foreign tax rate differential .....	6.2	2.6	(0.8)
Change in foreign tax rates .....	0.4	(0.5)	6.2
Estimated settlement of foreign tax audit.....	4.2	—	—
Nondeductible stock compensation expense.....	—	—	4.0
Other nondeductible expenses .....	10.3	5.7	3.6
Other .....	6.7	(5.0)	(3.5)
Provision for valuation allowance .....	<u>17.8</u>	<u>35.1</u>	<u>27.7</u>
	<u>8.0%</u>	<u>0.3%</u>	<u>1.1%</u>

On December 21, 2004, the FASB issued Staff Position No. FAS 109-2, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004 (FSP FAS 109-2). The American Jobs Creation Act ("AJCA") introduces a special one-time dividends received deduction on the repatriation of certain foreign earnings to a U.S. taxpayer (repatriation provision), provided certain criteria are met. FSP FAS 109-2 provides accounting and disclosure guidance for the repatriation provision. Although FSP FAS 109-2 was effective immediately, the standard allows additional time beyond the financial reporting period of enactment to evaluate the effect of the AJCA on the Company's plan for reinvestment or repatriation of foreign earnings for purposes of applying SFAS No. 109. The Company is currently evaluating the merits of repatriating funds under the AJCA and has not yet determined the impact of this statement on the Company. It has been the Company's practice to indefinitely reinvest all foreign earnings into foreign operations. Should the Company determine that the Company plans to repatriate any foreign earnings, the Company will be required to establish a deferred tax liability on such earnings through a charge to the income tax provision.

# MATRIXONE, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued) (In thousands, except per share amounts)

### Note 9: Commitments and Contingencies

#### *Commitments*

The Company leases its facilities, automobiles and certain office equipment under various operating leases that expire through fiscal 2011. Certain of the facility leases require the Company to pay its proportionate share of building expenses and provide the Company with the option to renew its lease for an extended period. Aggregate rental expense under operating leases was approximately \$5,352, \$4,850 and \$5,206 for fiscal 2005, 2004 and 2003, respectively.

Future minimum lease commitments, by fiscal year, as of July 2, 2005 are as follows:

<b>Fiscal Year</b>	<b>Facilities</b>	<b>Autos and Equipment</b>	<b>Total</b>
2006 .....	\$ 4,076	\$ 619	\$ 4,695
2007 .....	3,131	373	3,504
2008 .....	2,789	102	2,891
2009 .....	2,145	2	2,147
2010 .....	1,906	—	1,906
Thereafter .....	991	—	991
	<u>\$ 15,038</u>	<u>\$ 1,096</u>	<u>\$ 16,134</u>

In connection with certain product development agreements with third-party software developers for technology integrated into certain Business Process Applications and Enterprise Integration products, the Company is required to pay prepaid software license fees and development fees. Prepaid software license fees and development fees due under these contracts aggregated \$444 and \$1,917, respectively at July 2, 2005 and will be paid through April 2008. The Company also enters into contractual arrangements with certain of its vendors. The guaranteed amounts due under these contractual arrangements aggregate \$917 and are expected to be paid in varying amounts through June 2007.

#### *Contingencies*

On April 19, 2002, a consolidated amended class action complaint was filed in the United States District Court for the Southern District of New York. The complaint, which superseded five virtually identical complaints that had been filed from July 24, 2001 to September 5, 2001, names as defendants the Company, two of our officers, and certain underwriters involved in our initial public offering of common stock (“IPO”). The complaint is allegedly brought on behalf of purchasers of our common stock during the period from February 29, 2000 to December 6, 2000 and asserts, among other things, that our IPO prospectus and registration statement violated federal securities laws because they contained material misrepresentations and/or omissions regarding the conduct of our IPO underwriters in allocating shares in our IPO to the underwriters’ customers, and that the Company and the two named officers engaged in fraudulent practices with respect to the underwriters’ conduct. The action seeks damages, fees and costs associated with the litigation, and interest. We and our officers and directors believe that the allegations in the complaint are without merit and have defended the litigation vigorously. The litigation process is inherently uncertain and unpredictable, however, and there can be no guarantee as to the ultimate outcome of this pending lawsuit. Pursuant to a stipulation between the parties, the

## **MATRIXONE, INC.**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued) (In thousands, except per share amounts)**

Company's two named officers were dismissed from the lawsuit, without prejudice, on October 9, 2002. On February 19, 2003, the Court ruled on a motion to dismiss the complaint that had been filed by the Company, along with the three hundred plus other publicly-traded companies that have been named by various plaintiffs in substantially similar lawsuits. The Court granted the Company's motion to dismiss the claim filed against it under Section 10(b) of the Securities Exchange Act of 1934, but denied the Company's motion to dismiss the claim filed against it under Section 11 of the Securities Act of 1933, as it denied the motions under this statute for virtually every other company sued in the substantially similar lawsuits.

In June 2003, the Company, implementing the determination made by a special independent committee of the Board of Directors, elected to participate in a proposed settlement agreement with the plaintiffs in this litigation. If ultimately approved by the Court, this proposed settlement would result in a dismissal, with prejudice, of all claims in the litigation against us and against any of the other issuer defendants who elect to participate in the proposed settlement, together with the current or former officers and directors of participating issuers who were named as individual defendants. The proposed settlement does not provide for the resolution of any claims against the underwriter defendants, and the litigation as against those defendants is continuing. The proposed settlement provides that the class members in the class action cases brought against the participating issuer defendants will be guaranteed a recovery of \$1.0 billion by insurers of the participating issuer defendants. If recoveries totaling \$1.0 billion or more are obtained by the class members from the underwriter defendants, however, the monetary obligations to the class members under the proposed settlement will be satisfied. In addition, the Company and any other participating issuer defendants will be required to assign to the class members certain claims that they may have against the underwriters of their IPOs.

The proposed settlement contemplates that any amounts necessary to fund the settlement or settlement-related expenses would come from participating issuers' directors and officers liability insurance policy proceeds, as opposed to funds of the participating issuer defendants themselves. A participating issuer defendant could be required to contribute to the costs of the settlement if that issuer's insurance coverage were insufficient to pay that issuer's allocable share of the settlement costs. The Company expects that its insurance proceeds will be sufficient for these purposes and that it will not otherwise be required to contribute to the proposed settlement.

Consummation of the proposed settlement is conditioned upon obtaining final approval by the Court. On September 1, 2005, the Court preliminarily approved the proposed settlement, directed that notice of the terms of the proposed settlement be provided to class members, and scheduled a fairness hearing, at which objections to the proposed settlement will be heard. Thereafter, the Court will determine whether to grant final approval to the proposed settlement.

If the proposed settlement described above is not consummated, the Company intends to continue to defend the litigation vigorously. Moreover, if the proposed settlement is not consummated, the Company believes that the underwriters may have an obligation to indemnify the Company for the legal fees and other costs of defending this suit. While the Company cannot guarantee the outcome of these proceedings, the Company believes that the final result of these actions will have no material effect on its consolidated financial condition, results of operations or cash flows.

## MATRIXONE, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued) (In thousands, except per share amounts)

#### *Indemnifications*

The Company licenses software and sells services to its customers pursuant to contracts, which the Company refers to as a Software License Agreement (“SLA”) and Master Services Agreement (“MSA”), respectively. Each SLA and MSA contains the relevant terms of the contractual arrangement with the customer and generally includes certain provisions for indemnifying the customer against losses, expenses, and liabilities from damages that are finally awarded against the customer by a court of competent jurisdiction or that are agreed to by the Company in a written settlement agreement in the event the Company's software or services performed by the Company are found to infringe upon a patent, copyright, trademark, or other proprietary right of a third-party. The SLA and MSA generally limit the scope of and remedies for such indemnification obligations in a variety of industry-standard respects, including but not limited to, certain time and geography based scope limitations and a right to replace an infringing product.

The Company believes its internal development processes and other policies and practices limit its exposure related to the indemnification provisions of the SLA and MSA. In addition, the Company requires its employees to sign a proprietary information and inventions agreement, which assigns the rights of its employees' development work to the Company. To date, the Company has not had to reimburse any of its customers for any losses related to these indemnification provisions and no material claims are outstanding as of July 2, 2005. For several reasons, including the lack of prior indemnification claims and the lack of a monetary liability limit for certain infringement cases under the SLA and MSA, the Company cannot determine the maximum amount of potential future payments, if any, related to such indemnification provisions. However, the Company does not believe any amounts would be material to the Company's consolidated financial condition, results of operations or cash flows.

#### **Note 10: Stockholders' Equity**

##### *Common Stock*

On January 21, 2003, the Board of Directors (the “Board”) approved a stock repurchase program (the “Program”) whereby the Company was authorized to repurchase up to \$10,000 of its common stock, \$0.01 par value per share. Any common stock repurchases under the Program were able to be made over the one year period that began on January 27, 2003 and were able to be made in the open market, through block trades or otherwise. During fiscal 2005 and fiscal 2004, the Company did not purchase or retire any shares of its common stock under the Program. During fiscal 2003, the Company purchased and retired 300 shares of its common stock under the Program at an aggregate cost of \$1,036. The Program terminated on January 26, 2004.

##### *2000 Employee Stock Purchase Plan*

In December 1999, the Board adopted the 2000 Employee Stock Purchase Plan (the “Purchase Plan”) to be effective upon the completion of the Company's IPO. The Company has reserved a total of 1,350 shares of common stock for issuance under the Purchase Plan. On November 7, 2003, the stockholders of the Company approved an amendment to the Purchase Plan to increase the number of shares of common stock that may be issued pursuant to the Purchase Plan by 650 shares to 2,000 shares of common stock in the aggregate. Eligible employees may purchase common stock under the Purchase Plan at 85% of the lesser of the average market price

## MATRIXONE, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued) (In thousands, except per share amounts)

of the Company's common stock on the first or last day of the applicable six month payment period. During fiscal 2005, 2004 and 2003, 334 shares, 290 shares and 469 shares, respectively, of common stock were purchased under the Purchase Plan.

#### *Stock Option Plans*

In January 2000, the Board adopted the 1999 Plan to be effective upon the completion of the Company's IPO. In each year from fiscal 2001 through fiscal 2004, the 1999 Plan has been amended thereby increasing the number of shares of common stock issuable over the term of the 1999 Plan from 1,500 shares to 8,000 shares of common stock in the aggregate.

The 1999 Plan provides for the granting of incentive and nonqualified stock options, stock issuances and opportunities to make direct purchases of stock to employees, officers or consultants of the Company. Options may be granted at not less than the fair market value of the Company's common stock on the date of grant, as determined by the Board.

In fiscal 1996, the Company adopted the 1996 Plan and reserved 13,950 shares of the Company's common stock for issuance. The 1996 Plan provides for the granting of incentive stock options, nonqualified stock options and other stock rights. Options may be granted at not less than the fair market value of the Company's common stock on the date of grant, as determined by the Board.

The Company's 1987 Stock Option Plan (the "1987 Plan") has been terminated; however, options issued under the 1987 Plan remain outstanding. The 1987 Plan provided for the granting of both incentive stock options and nonqualified stock options. Incentive stock options were granted at the fair market value of the common stock on the date of grant, as determined by the Board.

Options granted under the 1999, 1996 and 1987 Plans generally vest over four years, except as noted below, and expire no later than ten years from the date of the grant. There were 1,095 shares available for future grant under the 1999 and 1996 Plans as of July 2, 2005.

On February 3, 2003, the Company announced that the Board approved a voluntary stock option exchange program (the "option exchange program"). The option exchange program provided eligible holders of outstanding, unexercised options to purchase shares of the Company's common stock issued pursuant to the 1996 Plan and the 1999 Plan with an exercise price of at least \$5.00 per share the opportunity to tender such options in exchange for new replacement options. The ratios of new replacement options to options tendered pursuant to the option exchange program were as follows: 4 for 5 for options with exercise prices of \$5.00 to \$9.99; 3 for 5 for options with exercise prices of \$10.00 to \$19.99; and 2 for 5 for options with exercise prices of \$20.00 or more. Members of the Company's Board and the Company's executive officers were not eligible to participate in the option exchange program. Options to purchase approximately 2,597 shares of the Company's common stock were tendered and cancelled on March 6, 2003 pursuant to the option exchange program, and the Company granted new replacement options to purchase an aggregate of approximately 1,216 shares of its common stock at an exercise price of \$5.92 per share on September 8, 2003 in exchange for the tendered and cancelled options. The new replacement options had an exercise price equal to the fair market value of the Company's common stock on the date the new replacement options were granted and vest quarterly over a 30-month period. Accordingly, the Company did not record any stock-based compensation expense as a result of the option exchange program.

**MATRIXONE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
**(In thousands, except per share amounts)**

On July 1, 2005, the Company accelerated the vesting of substantially all outstanding, unvested “out-of-the-money” options held by employees, officers and directors with exercise prices of at least \$5.75 per share, which was equal to 115% of the \$5.00 closing price of the Company’s common stock on the NASDAQ National Market on June 30, 2005. The vesting of options to purchase approximately 1.8 million shares of common stock with exercise prices ranging from \$5.82 per share to \$19.48 per share, with a weighted average exercise price of \$6.58 per share, were accelerated, including options to purchase approximately 495,000 shares held by executive officers of the Company and options to purchase 15,000 shares held by non-employee directors. The primary purpose of this vesting acceleration is to avoid recognizing stock-based compensation under SFAS 123(R) associated with these “out-of-the-money” options.

The following is a summary of the status of the Company’s stock options as of July 2, 2005, July 3, 2004 and June 28, 2003 and the stock option activity for all stock option plans during the years ending on those dates:

	<b>July 2, 2005</b>		<b>July 3, 2004</b>		<b>June 28, 2003</b>	
	<b>Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Shares</b>	<b>Weighted Average Exercise Price</b>
OUTSTANDING:						
Beginning balance .....	10,527	\$ 6.49	7,523	\$ 6.54	10,279	\$ 10.25
Granted .....	2,650	\$ 5.01	4,314	\$ 6.21	2,200	\$ 5.70
Exercised .....	(400)	\$ 1.91	(539)	\$ 1.82	(705)	\$ 0.66
Forfeited .....	(1,241)	\$ 7.93	(771)	\$ 8.76	(4,251)	\$ 15.94
Ending balance .....	<u>11,536</u>	<u>\$ 6.15</u>	<u>10,527</u>	<u>\$ 6.49</u>	<u>7,523</u>	<u>\$ 6.54</u>
EXERCISABLE .....	<u>9,247</u>	<u>\$ 6.43</u>	<u>6,056</u>	<u>\$ 6.23</u>	<u>4,969</u>	<u>\$ 5.22</u>

Information regarding options outstanding as of July 2, 2005 is as follows:

<b>Range of Exercise Price</b>	<b>Options Outstanding</b>			<b>Options Exercisable</b>	
	<b>Shares</b>	<b>Weighted Average Remaining Contractual Life (Years)</b>	<b>Weighted Average Exercise Price</b>	<b>Shares</b>	<b>Weighted Average Exercise Price</b>
\$ 0.33 - \$ 0.44 .....	2,196	2.41	\$ .44	2,196	\$ .44
\$ 1.11 - \$ 1.11 .....	508	4.06	\$ 1.11	508	\$ 1.11
\$ 2.41 - \$ 4.45 .....	537	7.30	\$ 3.48	322	\$ 3.40
\$ 4.47 - \$ 5.52 .....	2,427	8.81	\$ 4.93	565	\$ 5.03
\$ 5.55 - \$ 5.92 .....	2,769	8.14	\$ 5.90	2,637	\$ 5.91
\$ 5.93 - \$ 7.00 .....	1,185	7.55	\$ 6.81	1,156	\$ 6.82
\$ 7.02 - \$11.80 .....	764	6.95	\$ 7.98	739	\$ 7.97
\$12.06 - \$23.29 .....	740	5.84	\$ 13.74	716	\$ 13.74
\$27.56 - \$42.00 .....	<u>410</u>	<u>5.15</u>	<u>\$ 36.40</u>	<u>408</u>	<u>\$ 36.40</u>
	<u>11,536</u>	<u>6.58</u>	<u>\$ 6.15</u>	<u>9,247</u>	<u>\$ 6.43</u>

# MATRIXONE, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued) (In thousands, except per share amounts)

In connection with certain stock option grants to employees, the Company recorded deferred stock-based compensation of \$13,574 and \$4,080 in fiscal 2000 and fiscal 1999, respectively. Deferred stock-based compensation represents the difference between the option price and the deemed fair value of the Company's common stock on the date of grant and is reported as stock-based compensation, a component of stockholders' equity. Deferred stock-based compensation is amortized through charges to operations ratably over the vesting period of the options, which is generally four years. Stock-based compensation was \$567 and \$3,195 for fiscal 2004 and 2003, respectively. There was no stock-based compensation during fiscal 2005.

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its stock options.

The fair value of options granted in fiscal 2005, 2004 and 2003 have been determined using the Black-Scholes option pricing model and the following assumptions:

	Year Ended		
	July 2, 2005	July 3, 2004	June 28, 2003
Risk-free interest rate.....	3.10 – 4.04%	2.40 – 3.48%	1.89 – 3.41%
Expected dividend yield .....	None	None	None
Expected lives.....	3 – 4 years	4 years	4 years
Expected volatility.....	59-90%	90-120%	120%

The weighted average fair value of options granted in fiscal 2005, 2004 and 2003 were \$3.05, \$4.74 and \$4.48 per share, respectively.

### Note 11: Employee Benefit Plans

Eligible employees of the Company's U.S. operations may elect to participate in the Company's 401(k) plan. The Company does not make contributions to the 401(k) plan. Employees of certain of the Company's subsidiaries are provided with savings plans to which the Company and the employee contribute. The Company's contributions to these plans aggregated \$420, \$363 and \$240 in fiscal 2005, 2004 and 2003, respectively.

### Note 12: Segment and Geographic Information

Operating segments are identified as components of an enterprise about which separate discrete financial information is available to the chief operating decision maker, or decision-making group, in assessing performance and allocating resources. The Company's decision-making group, its executive management team, views the Company's operations and manages its business principally as one segment with two offerings: PLM software and related services. The executive management team evaluates these offerings based on their respective gross margins. Therefore, the financial information presented in these financial statements represents all the material financial information related to the Company's principal operating segment.

**MATRIXONE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued)**  
**(In thousands, except per share amounts)**

Revenues, including exports in such regions, and property and equipment by significant geographic region are as follows:

	<b>Year Ended</b>		
	<b>July 2, 2005</b>	<b>July 3, 2004</b>	<b>June 28, 2003</b>
		<b>(As Restated)</b>	<b>(As Restated)</b>
REVENUES:			
North America .....	\$ 68,764	\$ 57,200	\$ 60,600
Europe .....	41,454	38,362	28,967
Japan .....	9,507	10,419	9,955
Asia/Pacific (excluding Japan) .....	4,329	3,596	5,499
Total international .....	55,290	52,377	44,421
	<u>\$ 124,054</u>	<u>\$ 109,577</u>	<u>\$ 105,021</u>

The Company reports revenue in the geographic region of the customer at the time of the license. However, the customer may deploy licenses in other geographic regions.

	<b>As of</b>	
	<b>July 2, 2005</b>	<b>July 3, 2004</b>
PROPERTY AND EQUIPMENT, NET:		
North America .....	\$ 5,492	\$ 6,216
Europe .....	478	650
Japan .....	104	167
Asia/Pacific (excluding Japan) .....	22	29
Total international .....	604	846
	<u>\$ 6,096</u>	<u>\$ 7,062</u>

The Company's software products are primarily classified into three categories as set forth below. The software license revenues related to these software products are as follows.

	<b>Year Ended</b>		
	<b>July 2, 2005</b>	<b>July 3, 2004</b>	<b>June 28, 2003</b>
		<b>(As Restated)</b>	<b>(As Restated)</b>
Matrix PLM Platform .....	\$ 14,943	\$ 18,454	\$ 16,397
Business Process Applications .....	23,149	16,263	17,519
Enterprise Integrations .....	9,208	4,030	4,090
Total .....	<u>\$ 47,300</u>	<u>\$ 38,747</u>	<u>\$ 38,006</u>

No one customer accounted for more than 10% of the Company's total revenues during fiscal 2005, 2004 or fiscal 2003.



# MATRIXONE, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued) (In thousands, except per share amounts)

### Note 13: Quarterly Financial Information (unaudited)

As described in Note 3 “Restatement of Consolidated Financial Statements” the quarterly information for the first and second quarters for the fiscal year ended July 2, 2005 and the four quarters for the fiscal year ended July 3, 2004 have been restated. The effects of this restatement are reflected below.

#### Year Ended July 2, 2005

	First Quarter (As Reported)	First Quarter (As Restated)	Second Quarter (As Reported)	Second Quarter (As Restated)	Third Quarter	Fourth Quarter	Total
Revenues.....	\$ 29,616	\$ 28,682	\$ 35,106	\$ 35,841	\$ 27,016	\$ 32,515	\$ 124,054
Gross profit .....	\$ 16,726	\$ 16,144	\$ 20,684	\$ 22,060	\$ 14,049	\$ 17,311	\$ 69,564
Net income (loss) .....	\$ (1,938)	\$ (2,491)	\$ (399)	\$ 446	\$ (6,533)	\$ (11,743)	\$ (20,321)
Basic net income (loss) per share.....	\$ (0.04)	\$ (0.05)	\$ (0.01)	\$ 0.01	\$ (0.13)	\$ (0.23)	\$ (0.40)
Diluted net income (loss) per share .....	\$ (0.04)	\$ (0.05)	\$ (0.01)	\$ 0.01	\$ (0.13)	\$ (0.23)	\$ (0.40)
Shares used in computing basic net income (loss) per share.....	50,295	50,295	51,378	51,378	51,566	51,714	51,238
Shares used in computing diluted net income (loss) per share.....	50,295	50,295	51,378	53,980	51,566	51,714	51,238

#### Year Ended July 3, 2004

	First Quarter (As Reported)	First Quarter (As Restated)	Second Quarter (As Reported)	Second Quarter (As Restated)	Third Quarter (As Reported)	Third Quarter (As Restated)	Fourth Quarter (As Reported)	Fourth Quarter (As Restated)	Total (As Reported)	Total (As Restated)
Revenues.....	\$ 23,241	\$ 24,648	\$ 26,869	\$ 27,602	\$ 28,958	\$ 27,744	\$ 30,015	\$ 29,583	\$ 109,083	\$ 109,577
Gross profit .....	\$ 10,671	\$ 12,289	\$ 13,145	\$ 15,057	\$ 15,309	\$ 15,671	\$ 16,908	\$ 17,119	\$ 56,033	\$ 60,136
Net income (loss) .....	\$ (6,688)	\$ (5,355)	\$ (7,151)	\$ (5,539)	\$ (2,811)	\$ (2,439)	\$ 441	\$ 927	\$ (16,209)	\$ (12,406)
Basic net income (loss) per share.....	\$ (0.14)	\$ (0.11)	\$ (0.15)	\$ (0.11)	\$ (0.06)	\$ (0.05)	\$ 0.01	\$ 0.02	\$ (0.33)	\$ (0.26)
Diluted net income (loss) per share .....	\$ (0.14)	\$ (0.11)	\$ (0.15)	\$ (0.11)	\$ (0.06)	\$ (0.05)	\$ 0.01	\$ 0.02	\$ (0.33)	\$ (0.26)
Shares used in computing basic net income (loss) per share .....	47,953	47,953	48,210	48,210	48,394	48,394	48,596	48,596	48,411	48,411
Shares used in computing diluted net income (loss) per share.....	47,953	47,953	48,210	48,210	48,394	48,394	51,445	51,445	48,411	48,411

## **ITEM 9: CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

### **ITEM 9A. CONTROLS AND PROCEDURES**

Disclosure controls and procedures are designed with the objective of ensuring that information required to be disclosed in our reports filed or submitted under the Securities and Exchange Commission's rules and forms is recorded, processed, summarized and reported within the time periods specified under such rules and forms. Disclosure controls and procedures are also designed with the objective of ensuring that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of July 2, 2005, which included an evaluation of disclosure controls and procedures applicable to the period covered by the filing of this periodic report. Based on this evaluation, and due to the material weaknesses in our internal control over financial reporting as described in our accompanying Management Report on Internal Control Over Financial Reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act), our disclosure controls and procedures were not effective as of July 2, 2005 to ensure that the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the periods specified in the SEC's rules and forms. Management's report on our internal control over financial reporting and the independent registered public accounting firm's related audit report are included elsewhere in this Annual Report on Form 10-K.

In the third quarter of fiscal 2005, a new manager at our Japanese subsidiary discovered a side letter, a violation of our policy, which granted a distributor an unauthorized right to return certain of our software products. The manager informed our U.S. management about the side letter, who in turn notified our independent auditors and the Audit Committee of the Board of Directors. The Audit Committee of our Board of Directors launched a review of our revenue recognition practices. As a result of the review, we concluded that certain managers and employees principally in Japan did not comply with our revenue recognition policies, and did not provide accurate information to us concerning arrangements included as revenue in our consolidated financial statements. Based on the review, management and the Audit Committee concluded that these errors in revenue recognition, which primarily result in the deferral of revenue into later periods than originally recognized, required us to restate previously reported financial results. We also identified several customer arrangements in prior fiscal periods that included certain commitments to provide future software functionality resulting in the deferral of revenue into later periods when the commitment was or will be fulfilled. The restatement will affect previously reported results from fiscal 1999 through the second quarter of fiscal 2005.

In connection with the restatement, we assessed the effectiveness of our internal control over financial reporting as required under Section 404 of the Sarbanes-Oxley Act of 2002 and Item 308 of Regulation S-K. We identified and reported to our Audit Committee and independent registered public accounting firm the following material weaknesses in our internal control over financial reporting, as they existed as of July 2, 2005. These material weaknesses include entity-level control weaknesses as well as weaknesses in process and transaction controls as defined in the Committee of Sponsoring Organizations of the Treadway Commission (COSO) criteria.

Because of these material weaknesses, we concluded that as of July 2, 2005, our internal control over financial reporting was not effective based on the COSO control criteria. The nature of each of these material weaknesses is described below along with the actual or potential effects on our financial statements issued during the existence of the material weakness, and the remedial measures implemented by us to date or to be implemented, some of which will not in and of themselves remediate the material weaknesses and will require some time to be fully implemented or to take full effect.

The following material weaknesses collectively resulted in us prematurely recognizing revenue, thereby causing revenue to be overstated in an earlier period and understated in a later period, deferred revenue to be understated in any period, costs and expenses to vary in any particular period and our net loss to be understated in an earlier period and overstated in a later period. As a consequence, we have restated our historical financial statements, as described elsewhere herein, resulting in a (reduction) or increase in revenue in fiscal 2004 and fiscal 2003 of \$764 and (\$3,073), respectively and an (increase) or reduction in net loss in fiscal 2004 and fiscal 2003 of \$3,803 in 2004 and (\$3,722) in 2003.

***Inadequate communication and monitoring of policies and procedures.*** We do not have sufficient communication to employees regarding their duties and control responsibilities, and monitoring by management, to ensure adherence by our employees to our code of business conduct and revenue recognition policy; and we do not have sufficient communication with our employees, and monitoring by management, to ensure timely notification of actual or perceived violations of our policies and procedures. We consider these to be a deficiency that is also a material weakness in the operation of entity-level controls. If we are not successful in remedying the deficiencies that caused this material weakness, our quarterly or annual financial statements could be materially misstated, which could require a restatement.

- Beginning in the fourth quarter of fiscal 2005, we require all sales personnel to certify on a transaction by transaction basis whether they are aware of any unauthorized arrangements and other commitments with customers.
- In the fourth quarter of fiscal 2005, we amended our existing indirect channel revenue recognition policy and related written confirmation process to require additional information regarding terms and conditions between the indirect channel partner and the related end user, certain additional end user information and a copy of certain arrangements between the end user and the indirect channel partner.
- In the fourth quarter of fiscal 2005, we evaluated and began to implement more comprehensive procedures for the timely detection, prevention, and mitigation of improper activities.
- In the first quarter of fiscal 2006, we terminated the employment of certain employees who were found to have violated our policies and procedures.
- In the first quarter of fiscal 2006, we evaluated our relationships with each of our Japanese resellers, including reviewing arrangements with them to ensure that they are providing to us accurate documentation as required by our revenue recognition policy.
- In the first quarter of fiscal 2006, we modified our revenue recognition policy and required all sales and professional services personnel to certify their understanding and awareness of the policy which, among other things, provides that no employee may engage in verbal or written side agreements.
- In the first quarter of fiscal 2006, we implemented a new policy of obtaining certification from sales personnel and management on a quarterly basis that they are not aware of any side agreements or concessions, in addition to our existing procedure of obtaining such certification from sales personnel on a transaction by transaction basis.

- In the first quarter of fiscal 2006, we modified our code of business conduct and provided specific training for all of our senior management and training for other members of management and personnel. We are in the process of training all employees on a worldwide basis on the changes to our code of conduct and reiterating the pre-existing requirements regarding conduct and obligations to report violations.
- In the first quarter of fiscal 2006, we produced Japanese language versions of the revised code of business conduct and conducted in person training for all Japanese employees.
- In the first quarter of fiscal 2006, we instituted additional reporting mechanisms for the submission of information relating to a violation of our code of business conduct.
- In the first quarter of fiscal 2006, we began implementing electronic tracking software to monitor the execution of, and questions regarding, the code of business conduct and quarterly certifications.
- In the first quarter of fiscal 2006, we adopted new internal guidelines relating to communications with the Audit Committee.
- In the first quarter of fiscal 2006, we modified the procedures under which the appropriate persons within our global management team will have greater levels of involvement in, and oversight of, international operations.
- During fiscal 2006, we plan to implement organizational changes to clarify those persons responsible for finance, accounting and legal functions concerning our Japanese subsidiary report directly to and/or correspond with persons responsible for finance, accounting and legal functions at our corporate management team.

***Inadequate staffing and lack of certain requisite skills and competencies within the finance and accounting organization.*** As of July 2, 2005, we do not have a sufficient number of experienced personnel in our accounting and finance organization to facilitate the financial statement close process and permit the preparation of its financial statements in accordance with generally accepted accounting principles. Our personnel also lack certain required skills and competencies to oversee the accounting operations and review, periodically inspect and test, and investigate the transactions of our foreign locations and ensure sufficient segregation of duties and financial management. We consider this to be a deficiency that is also a material weakness in the operation of entity-level controls. If we are not successful in remedying the deficiencies that caused this material weakness, our quarterly or annual financial statements could be materially misstated, which could require a restatement.

- In the fourth quarter of fiscal 2005, we engaged a professional foreign language translation firm and used certain technology to assist in the independent translation of certain transactional documents and other foreign language arrangements.
- In the first quarter of fiscal 2006, we engaged an experienced financial consulting firm to assist us in providing additional financial and accounting services to review the financial activities and transactions at various international locations.
- In the first quarter of fiscal 2006, we hired a finance professional to fill the newly created position of Revenue Controller. This position will assist in the oversight, evaluation, and execution of our revenue related activities.
- During fiscal 2006, we plan to establish an internal audit process to review the financial activities of our domestic and international operations.

- During fiscal 2006, we plan to hire additional accounting, financial, and administrative personnel.

***Inadequate processes, personnel with requisite skills and competencies, and oversight to identify the full scope of the Company's arrangements with its customers.*** We do not have adequate staffing or personnel with requisite skills and competencies, revenue recognition processes, financial systems and controls, and management oversight to reasonably a) ensure the prevention and detection of unauthorized arrangements with customers, b) ensure the prevention and detection of concessions primarily related to maintenance terms and conditions, c) ensure that documentation of vendor specific objective evidence of services was sufficient; and d) evaluate the associated accounting implications. We did not have a sufficient number of personnel or personnel with requisite skills and competencies in our accounting and finance organization to provide reasonable assurance that complex multiple element arrangements were being recorded as necessary to facilitate the financial statement close process and permit preparation of financial statements in accordance with generally accepted accounting principles. As a result, material revenue-related adjustments have been posted to our books and records in our current and prior year financial statements. If we are not successful in remedying the deficiencies that caused this material weakness, our quarterly or annual financial statements could be materially misstated, which could require a restatement.

- In the fourth quarter of fiscal 2005, we amended our existing indirect channel revenue recognition policy and related written confirmation process to require additional information regarding certain terms and conditions between the indirect channel partner and the related end user, certain end user information and a copy of certain arrangements between the end user and the indirect channel partner.
- In the fourth quarter of fiscal 2005, we established a new policy which required that all sales personnel certify as to the awareness of any unauthorized arrangements and other commitments with customers.
- In the first quarter of fiscal 2006, we evaluated our relationships with each of our Japanese resellers, including reviewing arrangements with them to ensure that they are providing to us those materials required by our revenue recognition policy.
- In the first quarter of fiscal 2006, we modified our revenue recognition policy and required all sales and professional services personnel to certify their understanding and awareness of the policy which, among other things, provides that no employee may engage in verbal or written side agreements.
- In the first quarter of fiscal 2006, we modified our software license transaction certification, which is provided for each software license transaction to assist in detecting issues that may impact revenue recognition.
- In the first quarter of fiscal 2006, we began to conform certain finance and administration functions in Japan to that currently used for our other subsidiaries using corporate shared services.
- In the first quarter of fiscal 2006, we hired a finance professional to fill the newly created position of Revenue Controller. This position will assist in the oversight, evaluation, and execution of our revenue related activities.
- During fiscal 2006, we plan to hire additional domestic and international resources to assist in the oversight, evaluation, and execution of our revenue related activities.

During the fiscal quarter ended July 2, 2005, we have made changes, described above, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting (as defined in Rules 240.13a-15(f) and 240.15d-15(f) of the Exchange Act).

We continue to plan additional changes to our infrastructure and related processes that we believe are also reasonably likely to strengthen and materially affect our internal control over financial reporting.

We note, however, that a control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues including instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, our control systems may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected and could be material and require a restatement of our financial statements.

The certifications of our principal executive officer and principal financial officer required in accordance with Section 302 of the Sarbanes-Oxley Act of 2002 are attached as exhibits to this Annual Report on Form 10-K. The disclosures set forth in this Item 9A contain information concerning (i) the evaluation of our disclosure controls and procedures, and changes in internal control over financial reporting, referred to in paragraph 4 of the certifications, and (ii) material weaknesses in the design or operation of our internal control over financial reporting, referred to in paragraph 5 of the certifications. Those certifications should be read in conjunction with this Item 9A for a more complete understanding of the matters covered by the certifications.

## **ITEM 9B: OTHER INFORMATION**

None

### **PART III**

This document does not contain the information in Part III that was included in the Form 10-K filed by the Company with the SEC on November 9, 2005. The information required to be set forth in Part III of Form 10-K is included in the proxy statement for the 2005 Annual Meeting of Stockholders that accompanies this 2005 Annual Report. You may obtain a copy of the complete Form 10-K as filed with the SEC by accessing the website maintained by the SEC at [www.sec.gov](http://www.sec.gov), by accessing the investor relations section of the Company's website at [www.matrixone.com](http://www.matrixone.com) or by contacting the Company at MatrixOne, Inc., Attention of Brian Norris, Vice President of Investor Relations, 210 Littleton Road, Westford, MA 01886, or telephone number (978) 589-4040.

#### **ITEM 10: DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

Certain information concerning the directors and executive officers of the Company can be found in the section entitled "Occupations of Directors and Executive Officers" in the Company's definitive proxy statement (the "2005 Definitive Proxy Statement") for the Company's 2005 annual meeting of stockholders.

The information concerning compliance with Section 16(a) of the Exchange Act required under this item can be found in the section entitled "Section 16(a) Beneficial Ownership Reporting Compliance" in the 2005 Definitive Proxy Statement.

#### **ITEM 11: EXECUTIVE COMPENSATION**

Certain information concerning executive compensation can be found in the section entitled "Compensation and Other Information Concerning Directors and Officers" in the 2005 Definitive Proxy Statement.

#### **ITEM 12: SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Certain information concerning security ownership of certain beneficial owners and management can be found in the section entitled "Security Ownership of Certain Beneficial Owners and Management" in the 2005 Definitive Proxy Statement.

#### **ITEM 13: CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

Certain information concerning certain relationships and related transactions can be found in the section entitled "Certain Relationships and Related Transactions" in the 2005 Definitive Proxy Statement.

#### **ITEM 14: PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Certain information concerning certain principal accountant fees and services can be found in the section entitled "Accounting Fees" in the 2005 Definitive Proxy Statement.

## PART IV

### ITEM 15: EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

#### (a) (1) FINANCIAL STATEMENTS

The following Consolidated Financial Statements of the Company are filed as part of this report:  
Report of Independent Registered Public Accounting Firm  
Consolidated Balance Sheets as of July 2, 2005 and July 3, 2004 (restated)  
Consolidated Statements of Operations for the years ended July 2, 2005, July 3, 2004 (restated)  
and June 28, 2003 (restated)  
Consolidated Statements of Stockholders' Equity for the years ended July 2, 2005 July 3, 2004  
(restated) and June 28, 2003 (restated)  
Consolidated Statements of Cash Flows for the years ended July 2, 2005, July 3, 2004 (restated)  
and June 28, 2003 (restated)  
Notes to Consolidated Financial Statements

#### (2) FINANCIAL STATEMENT SCHEDULES

The following financial statement schedule of MatrixOne, Inc. for each of the fiscal years ended July 2, 2005, July 3, 2004 and June 28, 2003 is filed as part of this report and should be read in conjunction with the Consolidated Financial Statements and related notes thereto of MatrixOne, Inc.

#### Page Number

Schedule II-Valuation and Qualifying Accounts and Reserves

S-II

Schedules other than those listed above have been omitted since they are either not required, not applicable, or the information has otherwise been included.

#### (3) INDEX TO EXHIBITS

The Exhibits filed as part of this annual report on Form 10-K are listed in the Exhibit Index immediately preceding the exhibits and are incorporated by reference herein.



## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MATRIXONE, INC.

Date: November 8, 2005

By: /s/ Mark F. O'Connell  
Mark F. O'Connell  
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Company and in the capacities and on the dates indicated.

Signature	Title(s)	Date
<u>/s/ Mark F. O'Connell</u> <b>Mark F. O'Connell</b>	President, Chief Executive Officer and Director (principal executive officer)	
<u>/s/ Gary D. Hall</u> <b>Gary D. Hall</b>	Chief Financial Officer and Treasurer (principal financial and accounting officer)	
<u>/s/ Gregory R. Beecher</u> <b>Gregory R. Beecher</b>	Director	
<u>/s/ W. Patrick Decker</u> <b>W. Patrick Decker</b>	Director	
<u>/s/ David G. DeWalt</u> <b>David G. DeWalt</b>	Director	
<u>/s/ Daniel J. Holland</u> <b>Daniel J. Holland</b>	Director	
<u>/s/ Charles R. Stuckey, Jr.</u> <b>Charles R. Stuckey, Jr.</b>	Director	

## MATRIXONE, INC.

### MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting for our Company. Internal control over financial reporting is defined in Rule 13a-15(f) promulgated under the Exchange Act as a process designed by, or under the supervision of, a company's principal executive and principal financial officers and effected by the Company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

#### ***Material Weaknesses***

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

We assessed the effectiveness of our internal control over financial reporting as of July 2, 2005, which identified the following material weaknesses in our internal control over financial reporting as of July 2, 2005. These material weaknesses include both entity level control weaknesses as well as weaknesses in process and transaction controls as defined in the COSO criteria. These material weaknesses collectively resulted in us prematurely recognizing revenue, thereby causing, for any transaction or series of transactions, revenue to be overstated in an earlier period and understated in a later period, deferred revenue to be understated in any period and certain operating expenses and net loss to be understated in an earlier period and overstated in a later period. As a consequence, we have restated our historical financial statements, as described elsewhere herein, resulting in a (reduction) or increase in total revenue in fiscal 2004 and fiscal 2003 of \$764 and (\$3,073), respectively and an (increase) or reduction in net loss in fiscal 2004 and fiscal 2003 of \$3,803 in 2004 and (\$3,722) in 2003.

***Inadequate communication and monitoring of policies and procedures.*** We do not have sufficient communication to employees regarding their duties and control responsibilities, and monitoring by management, to ensure adherence by our employees to our code of business conduct and revenue recognition policy; and we did not have sufficient communication with our employees, and monitoring by management, to ensure timely notification of actual or perceived violations of our policies and procedures. We consider these to be a deficiency in the operation of entity-level controls. If we are not successful in remedying the deficiencies that caused this

material weakness, our quarterly or annual financial statements could be materially misstated, which could require a restatement.

***Inadequate staffing and lack of certain requisite skills and competencies within the finance and accounting organization.*** We do not have a sufficient number of experienced personnel in our accounting and finance organization to facilitate the financial statement close process and permit the preparation of its financial statements in accordance with generally accepted accounting principles. Our personnel also lack certain requisite skills and competencies to oversee the accounting operations and review, periodically inspect and test, and investigate the transactions of our foreign locations and ensure sufficient segregation of duties and financial management to facilitate the financial statement close process and permit the preparation of financial statements in accordance with generally accepted accounting principles. We consider this to be a deficiency in the operation of entity-level controls. If we are not successful in remedying the deficiencies that caused this material weakness, our quarterly or annual financial statements could be materially misstated, which could require a restatement.

***Inadequate processes, personnel with requisite skills and competencies, and oversight to identify the full scope of the Company's arrangements with its customers.*** We do not have adequate staffing or personnel with requisite skills and competencies, revenue recognition processes, financial systems and controls, and management oversight to reasonably a) ensure the prevention and detection of unauthorized arrangements with customers, b) ensure the prevention and detection of concessions primarily related to maintenance terms and conditions, c) ensure that documentation of vendor specific objective evidence of services was sufficient; and d) evaluate the associated accounting implications. We do not have a sufficient number of personnel or personnel with requisite skills and competencies in our accounting and finance organization to provide reasonable assurance that complex multiple element arrangements were being recorded as necessary to facilitate the financial statement close process and permit the preparation of financial statements in accordance with generally accepted accounting principles. As a result, material revenue-related adjustments have been posted to our books and records in our current and prior year financial statements. If we are not successful in remedying the deficiencies that caused this material weakness, our quarterly or annual financial statements could be materially misstated, which could require a restatement.

In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control-Integrated Framework. Because of the material weaknesses described above, management believes that, as of July 2, 2005, our internal control over financial reporting was not effective based on those criteria.

Ernst & Young LLP, our independent registered public accounting firm, has issued a report on our assessment of our internal control over financial reporting. This report appears on page 61.

## MATRIXONE, INC.

VALUATION AND QUALIFYING ACCOUNTS AND RESERVES  
(in thousands)

	<b>Balance at Beginning of Period</b>	<b>Charged to Costs and Expenses</b>	<b>Charged to Other Accounts</b>	<b>Write-Offs/ Other Deductions</b>	<b>Balance at End of Period</b>
	<b>(As Restated)</b>	<b>(As Restated)</b>			<b>(As Restated)</b>
Allowance for Doubtful Accounts:					
July 2, 2005.....	\$ 867	\$ (117) <sup>(1)</sup>	\$ —	\$ (3)	\$ 747
July 3, 2004.....	\$ 945	\$ (76) <sup>(1)</sup>	\$ —	\$ (2)	\$ 867
June 28, 2003 .....	\$ 1,085	\$ 420	\$ —	\$ (560)	\$ 945

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<sup>(1)</sup>Amount represents a revision of an estimate reducing the allowance for doubtful accounts.

## EXHIBIT INDEX

<b><u>Exhibit No.</u></b>	<b><u>Description</u></b>
3.1(1)	Amended and Restated Certificate of Incorporation
3.2(1)	Amended and Restated By-laws
4.1(1)	Specimen certificate representing the common stock
4.2(2)	Registration Rights Agreement dated as of August 4, 2004 by and between MatrixOne, Inc. and the representative of former noteholders and certain stockholders of Synchronicity Software, Inc.
4.3	Amendment to Synchronicity AgreementS dated November 8, 2005 by and between MatrixOne, Inc. and James Furnivall, as the representative for the Holders
10.1(1)	Amended and Restated 1987 Stock Option Plan
10.2(1)	2000 Employee Stock Purchase Plan
10.3(1)	Loan and Security Agreement between the Company and Silicon Valley Bank dated as of December 29, 1998
10.4(1)	Loan Modification Agreement between the Company and Silicon Valley Bank dated as of September 28, 1999
10.5(1)	Loan Modification Agreement between the Company and Silicon Valley Bank dated as of December 28, 1999
10.6(3)	Loan Modification Agreement between the Company and Silicon Valley Bank dated as of August 18, 2000
10.7(4)	Sublease and Consent Agreement made as of December 1, 2000 by and between Veryfine Products, Inc. and the Company
10.8(4)	Loan Modification Agreement dated December 29, 2000 between the Company and Silicon Valley Bank
10.9(5)	Office Lease by and between the Company and Crown Milford LLC dated May 31, 2001
10.10(6)	Loan Modification Agreement between the Company and Silicon Valley Bank dated as of December 29, 2001
10.11(7)	Loan Modification Agreement between the Company and Silicon Valley Bank dated as of December 24, 2002
10.12(8)	Third Amended and Restated 1996 Stock Plan
10.13(8)	Amended and Restated 1999 Stock Plan
10.14(9)(*)	Letter agreement dated April 15, 2003 between the Company and Janet Heppner-Jones
10.15(10)	Loan Modification Agreement between the Company and Silicon Valley Bank dated as of December 23, 2003
10.16(10)(*)	Employment Agreement between the Company and Mark F. O'Connell dated as of October 21, 2003
10.17(10)(*)	Employment Letter between the Company and Sam Zawaideh dated as of November 3, 2003
10.18(10)(*)	Employment Letter between the Company and Mike Segal dated as of November 6, 2003
10.19(10)(*)	Employment Letter between the Company and John Fleming dated as of November 5, 2003
10.20(10)(*)	Employment Letter between the Company and Janet Heppner-Jones dated as of November 1, 2003
10.21(10)(*)	Employment Letter between the Company and David McNelis dated as of November 7, 2003
10.22(11)(*)	Employment Letter between the Company and Deborah Deputat dated as of March 25, 2004
10.23(11)(*)	Employment Letter between the Company and Deborah Deputat dated as of March 25, 2004
10.24(12)	Agreement and Plan of Merger by and among the Company, MatrixOne International, Inc., Insync Merger Corporation, Synchronicity Software, Inc., the noteholders and certain stockholders of Synchronicity Software, Inc. and James Furnivall as the representative, dated as of June 4, 2004
10.25(2)	Payment, Exchange and Escrow Agreement dated as of August 4, 2004 among MatrixOne, Inc., the Representative, Equiserve Trust Company, N.A., as Exchange Agent and U.S. Bank National Association, as Escrow Agent.
10.26(13)	Employment Letter between the Company and Gary D. Hall dated as of February 1, 2005
10.27(8)(*)	Form of Stock Option Agreement granted under Amended and Restated 1999 Stock Plan

- 10.28(13) Sales Compensation Plan Amendment between the Company and Janet Heppner-Jones dated as of January 3, 2005
- 10.29(13) 2005 Management Incentive Bonus Plan
- 21.1 Subsidiaries of the Company
- 23.1 Consent of Ernst & Young LLP
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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- (1) Incorporated herein by reference to the exhibits to the Company's Registration Statement on Form S-1 (File No. 333-92731).
  - (2) Incorporated herein by reference to the exhibits to the Company's Current Report on Form 8-K filed on August 10, 2004.
  - (3) Incorporated herein by reference to the exhibits to the Company's Annual Report on Form 10-K for the year ended July 1, 2000.
  - (4) Incorporated herein by reference to the exhibits to the Company's Quarterly Report on Form 10-Q for the quarterly period ended December 30, 2000.
  - (5) Incorporated herein by reference to the exhibits to the Company's Annual Report on Form 10-K for the year ended June 30, 2001.
  - (6) Incorporated herein by reference to the exhibits to the Company's Quarterly Report on Form 10-Q for the quarterly period ended December 29, 2001.
  - (7) Incorporated herein by reference to the exhibits to the Company's Quarterly Report on Form 10-Q for the quarterly period ended December 28, 2002.
  - (8) Incorporated herein by reference to the exhibits to the Company's Tender Offer Statement on Schedule TO (File No. 005-60481).
  - (9) Incorporated herein by reference to the exhibits to the Company's Annual Report on Form 10-K for the year ended June 28, 2003.
  - (10) Incorporated herein by reference to the exhibits to the Company's Quarterly Report on Form 10-Q for the quarterly period ended January 3, 2004.
  - (11) Incorporated herein by reference to the exhibits to the Company's Quarterly Report on Form 10-Q for the quarterly period ended April 3, 2004.
  - (12) Incorporated herein by reference to the exhibits to the Company's Current Report on Form 8-K filed on June 7, 2004.
  - (13) Incorporated herein by reference to the exhibits to the Company's Quarterly Report on Form 10-Q for the period ended April 2, 2005
  - (\*) Indicates a management contract or any compensatory plan, contract or arrangement.

**EXHIBIT 23.1**

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the Registration Statements (Form S-8 Nos. 333-66458, 333-81176, 333-35310 and 333-111610) pertaining to the 1987 Stock Option Plan, Third Amended and Restated 1996 Stock Plan, Amended and Restated 1999 Stock Plan and 2000 Employee Stock Purchase Plan of MatrixOne, Inc. of our reports dated November 8, 2005 with respect to the consolidated financial statements and schedule of MatrixOne, Inc., MatrixOne, Inc. management's assessment of the effectiveness of internal control over financial reporting, and the effectiveness of internal control over financial reporting of MatrixOne, Inc. included in the Annual Report (Form 10-K) for the year ended July 2, 2005.

/s/ Ernst & Young LLP

Boston, Massachusetts  
November 8, 2005

## **EXHIBIT 31.1**

### **CERTIFICATION**

I, Mark F. O'Connell, certify that:

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

Date: November 8, 2005

/s/ Mark F. O'Connell

Mark F. O'Connell

President and Chief Executive Officer



## **EXHIBIT 31.2**

### **CERTIFICATION**

I, Gary D. Hall, certify that:

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

Date: November 8, 2005

/s/ Gary D. Hall

Gary D. Hall

Chief Financial Officer and Treasurer

## **EXHIBIT 32.1**

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

In connection with this Annual Report on Form 10-K of MatrixOne, Inc. (the “Company”) for the fiscal year ended July 2, 2005, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Mark F. O’Connell, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the undersigned’s knowledge:

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

/s/ Mark F. O’Connell  
Mark F. O’Connell  
President and Chief Executive Officer

November 8, 2005

**EXHIBIT 32.2**

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

In connection with this Annual Report on Form 10-K of MatrixOne, Inc. (the “Company”) for the fiscal year ended July 2, 2005, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Gary D. Hall, Acting Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the undersigned’s knowledge:

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

/s/ Gary D. Hall  
Gary D. Hall  
Chief Financial Officer

November 8, 2005

## Corporate Information

### Directors:

**Gregory R. Beecher**

Vice President and Chief Financial Officer,  
Teradyne, Inc.

**W. Patrick Decker**

Director and Former President and Chief  
Operating Officer, Kronos Incorporated

**David G. DeWalt**

President, EMC Software Group, EMC Corporation

**Daniel J. Holland**

Senior Advisor, Flagship Ventures

**Mark F. O'Connell**

President and Chief Executive Officer,  
MatrixOne, Inc.

**Charles R. Stuckey, Jr.**

Director and Former Chairman of the Board  
and Chief Executive Officer, RSA Security, Inc.

### Executive Officers:

**Mark F. O'Connell**

President and Chief Executive Officer

**John C. Fleming**

Senior Vice President and General Manager  
Electronics Business Unit

**Gary D. Hall**

Senior Vice President of Finance,  
Chief Financial Officer and Treasurer

**David W. McNelis**

Senior Vice President of Engineering

**Michael Segal**

Senior Vice President of Global Sales  
and Services

**Deborah A. Mulryan**

Senior Vice President of Human Resources

**Sam Zawaideh**

Senior Vice President of Product Solutions  
and Customer Support

### Corporate Office:

MatrixOne, Inc.  
210 Littleton Road  
Westford, Massachusetts 01886  
Corporate Telephone: 978 589 4000  
Investor Relations Telephone: 978 589 4040  
MatrixOne.com

### Financial Information:

The accompanying Annual Report on Form 10-K for the fiscal year ended July 2, 2005 does not contain exhibits. These exhibits have been filed with the Securities and Exchange Commission. Upon request to our Office of Investor Relations, the Company will furnish, without charge, any such exhibits, as well as copies of periodic reports filed with the Securities and Exchange Commission and additional information about the Company, its products, and the markets it serves.

You can sign up for the Company's email alert system at [MatrixOne.com/investor](http://MatrixOne.com/investor), which will give you email notification of updates to the Company's investor relations Website.

### Stock Listing:

NASDAQ National Market Trading Symbol: MONE

### Annual Meeting:

The Annual Meeting of Stockholders will be held at 1:00 P.M. on December 22, 2005, at the law offices of Wilmer Cutler Pickering Hale and Dorr LLP located at 60 State Street Boston, Massachusetts 02109.

### Independent Auditors:

Ernst & Young, LLP - Boston, Massachusetts

### Legal Counsel:

Wilmer Cutler Pickering Hale and Dorr LLP  
Boston, Massachusetts

### Transfer Agent and Registrar:

EquiServe Trust Company, N.A. is the transfer agent and registrar for the Company's common stock and maintains stockholder accounting records. The Transfer Agent will respond to questions regarding changes in address, name, or ownership; lost certificates; and consolidation of accounts. A change of address should be reported promptly by sending a signed and dated letter to EquiServe Trust Company, N.A.

Stockholders should state the name in which the stock is registered, account number, social security number, certificate number, and the new address. Please mail correspondence to:

EquiServe Trust Company, N.A.  
c/o Computershare  
PO Box 43023  
Providence, RI 02940-3023  
781 575 2879  
[www.computershare.com](http://www.computershare.com)





210 Littleton Road, Westford, Massachusetts 01886 978 589 4000 [MatrixOne.com](http://MatrixOne.com)