

CHORDIANT SOFTWARE INC  
Form 10-Q  
November 03, 2003

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

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FORM 10-Q

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(Mark One)

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

for the quarterly period ended September 30, 2003

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-29357

Chordiant Software, Inc.

(Exact name of Registrant as specified in its Charter)

Delaware

(State or Other Jurisdiction of Incorporation or Organization)

93-105328

(I.R.S. Employer Identification Number)

**20400 Stevens Creek Boulevard, Suite 400**

**Cupertino, CA 95014**

(Address of Principal Executive Offices including Zip Code)

**(408) 517-6100**

(Registrant's Telephone Number, Including Area Code)

(Former name, former address and former fiscal year if changed since last report)

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

The number of shares of the Registrant's common stock outstanding as of October 29, 2003 was 64,674,358.

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**CHORDIANT SOFTWARE, INC.**  
**QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED SEPTEMBER 30, 2003**  
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**PART I -- FINANCIAL INFORMATION**

**Item 1. Condensed Consolidated Financial Statements**

**CHORDIANT SOFTWARE, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(In thousands)  
(Unaudited)**

|  | <u>September 30, 2003</u> | <u>December 31, 2002</u> |
|--|---------------------------|--------------------------|
| <b>ASSETS</b>                              |                           |                          |
| Current assets:                            |                           |                          |
| Cash and cash equivalents                  | \$ 32,094                 | \$ 30,731                |
| Short-term investments and restricted cash | 581                       | 9,245                    |
| Accounts receivable, net                   | 15,226                    | 15,343                   |
| Prepaid expenses and other current assets  | 3,096                     | 3,162                    |
|  | <u>50,997</u>             | <u>58,481</u>            |
| Total current assets                       | 50,997                    | 58,481                   |
| Restricted cash                            | 1,500                     | 1,500                    |
| Property and equipment, net                | 3,313                     | 5,069                    |

|   | <u>September 30, 2003</u>   | <u>December 31, 2002</u>    |
|---|-----------------------------|-----------------------------|
| Goodwill, net                               | 24,874                      | 24,874                      |
| Intangible assets, net                      | 2,304                       | 4,975                       |
| Other assets                                | 2,308                       | 1,788                       |
|   | <u>                    </u> | <u>                    </u> |
| Total assets                                | \$ 85,296                   | \$ 96,687                   |
|   | <u>                    </u> | <u>                    </u> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                             |                             |
| Current liabilities:                        |                             |                             |
| Borrowings                                  | \$ 1,191                    | \$ 1,114                    |
| Accounts payable                            | 2,797                       | 5,936                       |
| Accrued expenses                            | 11,327                      | 14,007                      |
| Deferred revenue                            | 16,722                      | 15,990                      |
|   | <u>                    </u> | <u>                    </u> |
| Total current liabilities                   | 32,037                      | 37,047                      |
| Deferred revenue, long-term                 | 5,241                       | 8,532                       |
| Borrowings, long-term                       | 940                         | 136                         |
| Other liabilities                           | 90                          | 161                         |
|   | <u>                    </u> | <u>                    </u> |
| Total liabilities                           | 38,308                      | 45,876                      |
|   | <u>                    </u> | <u>                    </u> |
| Stockholders' equity:                       |                             |                             |
| Common stock                                | 55                          | 55                          |
| Treasury stock                              | (332)                       | (332)                       |
| Additional paid-in capital                  | 233,774                     | 230,192                     |
| Notes receivable from stockholders          | --                          | (496)                       |
| Deferred stock-based compensation           | (3,446)                     | (6,750)                     |
| Accumulated deficit                         | (184,969)                   | (172,503)                   |
| Accumulated other comprehensive income      | 1,906                       | 645                         |
|   | <u>                    </u> | <u>                    </u> |
| Total stockholders' equity                  | 46,988                      | 50,811                      |
|   | <u>                    </u> | <u>                    </u> |
| Total liabilities and stockholders' equity  | \$ 85,296                   | \$ 96,687                   |
|   | <u>                    </u> | <u>                    </u> |

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

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(In thousands, except per share data)  
(Unaudited)

|   | Three Months Ended    |                       | Nine Months Ended     |                       |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
|   | September<br>30, 2003 | September<br>30, 2002 | September<br>30, 2003 | September<br>30, 2002 |
| <b>Revenues:</b>                              |                       |                       |                       |                       |
| License                                       | \$ 6,642              | \$ 8,625              | \$ 17,266             | \$ 25,747             |
| Service                                       | 11,124                | 10,276                | 31,400                | 31,038                |
| <b>Total revenues</b>                         | <b>17,766</b>         | <b>18,901</b>         | <b>48,666</b>         | <b>56,785</b>         |
| <b>Cost of revenues:</b>                      |                       |                       |                       |                       |
| License                                       | 267                   | 163                   | 847                   | 1,218                 |
| Service                                       | 6,406                 | 7,018                 | 18,356                | 23,177                |
| Non-cash compensation expense                 | 343                   | 62                    | 1,121                 | 233                   |
| <b>Total cost of revenues</b>                 | <b>7,016</b>          | <b>7,243</b>          | <b>20,324</b>         | <b>24,628</b>         |
| <b>Gross profit</b>                           | <b>10,750</b>         | <b>11,658</b>         | <b>28,342</b>         | <b>32,157</b>         |
| <b>Operating expenses:</b>                    |                       |                       |                       |                       |
| <b>Sales and marketing:</b>                   |                       |                       |                       |                       |
| Non-cash compensation expense                 | 304                   | 77                    | 995                   | 313                   |
| Other sales and marketing expense             | 4,995                 | 7,619                 | 15,728                | 25,038                |
| <b>Research and development:</b>              |                       |                       |                       |                       |
| Non-cash compensation expense                 | 414                   | 212                   | 1,279                 | 602                   |
| Other research and development expense        | 4,110                 | 5,281                 | 12,075                | 15,382                |
| Purchased in-process research and development | --                    | --                    | --                    | 997                   |
| <b>General and administrative:</b>            |                       |                       |                       |                       |
| Non-cash compensation expense                 | 675                   | 61                    | 1,653                 | 222                   |
| Other general and administrative expense      | 1,432                 | 2,323                 | 4,942                 | 6,448                 |
| Amortization of intangible assets             | 890                   | 954                   | 2,671                 | 2,732                 |
| Restructuring expense                         | --                    | 225                   | 1,161                 | 4,723                 |
| <b>Total operating expenses</b>               | <b>12,820</b>         | <b>16,752</b>         | <b>40,504</b>         | <b>56,457</b>         |
| <b>Loss from operations</b>                   | <b>(2,070)</b>        | <b>(5,094)</b>        | <b>(12,162)</b>       | <b>(24,300)</b>       |

|  |                   |                   |                    |                    |
|--|-------------------|-------------------|--------------------|--------------------|
| Interest expense                             | (37)              | (68)              | (131)              | (161)              |
| Other income (expense), net                  | (22)              | 194               | (173)              | 736                |
| <b>Net loss</b>                              | <b>\$ (2,129)</b> | <b>\$ (4,968)</b> | <b>\$ (12,466)</b> | <b>\$ (23,725)</b> |
| <b>Net loss per share:</b>                   |                   |                   |                    |                    |
| Basic and diluted                            | \$ (0.04)         | \$ (0.09)         | \$ (0.22)          | \$ (0.43)          |
| <b>Shares used in per share calculation:</b> |                   |                   |                    |                    |
| Basic and diluted                            | 60,037            | 55,547            | 57,327             | 54,726             |

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

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CHORDIANT SOFTWARE, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands)  
(Unaudited)

|   | <b>Nine Months Ended</b>      |                               |
|---|-------------------------------|-------------------------------|
|   | <b>September 30,<br/>2003</b> | <b>September 30,<br/>2002</b> |
| <b>Cash flows from operating activities:</b>                                |                               |                               |
| Net loss  | \$ (12,466)                   | \$ (23,725)                   |
| Adjustments to reconcile net loss to net cash used in operating activities: |                               |                               |
| Depreciation and amortization   | 2,088                         | 2,915                         |
| Amortization of intangibles   | 2,671                         | 2,732                         |
| Non-cash compensation expense   | 5,048                         | 1,369                         |
| Provision for doubtful accounts   | 21                            | 554                           |
| Warrants issued to customers  | 55                            | --                            |
| (Gain) loss on disposal of assets   | 88                            | (7)                           |
| Purchased in-process research and development                               | --                            | 997                           |
| Changes in assets and liabilities:  |                               |                               |
| Accounts receivable   | 96                            | 6,790                         |
| Prepaid expenses and other current assets                                   | 66                            | 2,263                         |
| Other assets  | (520)                         | (273)                         |
| Accounts payable  | (3,139)                       | 296                           |
| Accrued expenses  | (2,537)                       | 2,084                         |
| Deferred revenue  | (2,559)                       | (3,880)                       |
| Other liabilities   | (71)                          | (800)                         |
| <b>Net cash used in operating activities</b>                                | <b>(11,159)</b>               | <b>(8,685)</b>                |

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|   | Nine Months Ended |              |
|---|-------------------|--------------|
|   | 2019              | 2018         |
| Cash flows from investing activities:                                   |                   |              |
| Property and equipment purchases  | (438)             | (1,100)      |
| Proceeds from disposal of property and equipment                        | 18                | 88           |
| Cash used for acquisition, net of cash acquired                         | --                | (4,768)      |
| Restricted cash   | 44                | --           |
| Purchases of short-term investments                                     | (576)             | (9,044)      |
| Proceeds from sales and maturities of short-term investments            | 9,196             | 21,182       |
|   | <u>8,244</u>      | <u>6,358</u> |
| Cash flows from financing activities:                                   |                   |              |
| Exercise of stock options   | 359               | 1,490        |
| Proceeds from issuance of common stock                                  | --                | 3,029        |
| Proceeds from issuance of common stock for employee stock purchase plan | 1,281             | 1,542        |
| Proceeds from borrowings  | 3,491             | 444          |
| Repayment of notes receivable   | 496               | --           |
| Repayment of borrowings   | (2,610)           | (1,128)      |
|   | <u>3,017</u>      | <u>5,377</u> |
| Effect of exchange rate changes on cash and cash equivalents            | 1,261             | 714          |
|   | <u>1,363</u>      | <u>3,764</u> |
| Cash and cash equivalents at beginning of period                        | 30,731            | 27,068       |
| Cash and cash equivalents at end of period                              | \$ 32,094         | \$ 30,832    |
| Supplemental noncash activities:  |                   |              |
| Common stock issued for stockholder notes                               | \$ --             | \$ 496       |
| Issuance of warrants  | \$ --             | \$ 112       |
| Compensation expense relating to change in status of employee           | \$ --             | \$ 58        |
| Compensation expense relating to issuance of common stock to employees  | \$ 130            | \$ --        |

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

**CHORDIANT SOFTWARE, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(UNAUDITED)**

**NOTE 1--BASIS OF PRESENTATION:**

The accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting of only normal and recurring items, which in the opinion of management, are necessary to present fairly the financial position, results of operations and cash flows for the interim periods presented. The results of operations for interim periods are not necessarily indicative of the results expected for the full fiscal year or for any future period. These financial statements should be read in conjunction with the consolidated financial statements and related notes included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2002.

We believe that the effects of our strategic actions implemented to improve revenue as well as control costs will be adequate to generate sufficient cash resources to fund our operations for the reasonably foreseeable future. Failure to generate sufficient revenues or control spending could adversely affect our ability to achieve our business objectives.

**NOTE 2--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:**

Reclassifications

Certain reclassifications have been made to prior year balances to conform to current year presentation.

Principles of consolidation

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

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Such estimates include the allowance for doubtful accounts, valuation of goodwill and intangible assets, valuation of deferred tax assets, restructuring costs, contingencies and the estimates associated with the percentage-of-completion method of accounting for certain of our revenue contracts. We base our estimates on historical experience and on various other assumptions that are believed to be 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 under different assumptions or conditions.

**Revenue recognition**

We derive revenues from licenses of our software and related services, which include assistance in implementation, customization and integration, post-contract customer support, training and consulting. The amount and timing of our revenue is difficult to predict and any shortfall in revenue or delay in recognizing revenue could cause our operating results to vary significantly from quarter to quarter and could result in operating losses.

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At the time of entering into a transaction, we assess whether any services included within the arrangement require us to perform significant implementation or customization essential to the functionality of our products. For contracts involving significant implementation or customization essential to the functionality of our products, we recognize the license and professional consulting services revenues using the percentage-of-completion method using labor hours incurred as the measure of progress towards completion as prescribed by Statement of Position ("SOP") No. 81-1, "Accounting for Performance of Construction-Type and Certain Product-Type Contracts." The progress toward completion is measured based on the "go-live date." We define the "go-live date" as the date on which the essential product functionality has been delivered or on which the application enters into a production environment or the point at which no significant additional Chordiant supplied professional services resources are required. Estimates are subject to revisions as the contract progresses to completion. We account for

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the change in estimate in the period the change has been identified. Provisions for estimated contract losses are recognized in the period in which the loss becomes probable and can be reasonably estimated. When we sell additional licenses related to the original licensing agreement, revenue is recognized either upon delivery if the project has reached the go-live date, or if the project has not reached the go-live date, revenue is recognized under the percentage-of-completion method. We classify revenues from these arrangements as license and service revenues based upon the estimated fair value of each element.

On contracts for products not involving significant implementation or customization essential to the product functionality, we recognize license revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, collection of the fee is probable and delivery has occurred as prescribed by SOP No. 97-2, "Software Revenue Recognition."

We assess collection based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. We do not request collateral from our customers. If we determine that collection of a fee is not probable, we defer the fee and recognize revenue at the time collection becomes probable, which is generally upon receipt of cash.

For arrangements with multiple elements, we recognize revenue for services and post-contract customer support based upon vendor specific objective evidence ("VSOE") of fair value of the respective elements. VSOE of fair value for the services element is based upon the standard hourly rates we charge for services when such services are sold separately. VSOE of fair value for annual post-contract customer support is established with the optional stated future renewal rates included in the contracts. When contracts contain multiple elements, and VSOE of fair value exists for all undelivered elements, we account for the delivered elements, principally the license portion, based upon the "residual method" as prescribed by SOP No. 98-9, "Modification of SOP No. 97-2 with Respect to Certain Transactions."

In situations in which we are obligated to provide unspecified additional software products in the future, we recognize revenue as a subscription ratably over the term of the commitment period.

For all sales we use either a signed license agreement or a binding purchase order as evidence of an arrangement. Sales through our third party systems integrators are evidenced by a master agreement governing the relationship together with binding purchase orders on a transaction-by-transaction basis. Revenues from reseller arrangements are recognized on the "sell-through" method, when the reseller reports to us the sale of our software products to end-users. Our agreements with customers and resellers do not contain product return rights.

We recognize revenue for post-contract customer support ratably over the support period, generally one year. Our training and consulting services revenues are recognized as such services are performed.

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#### **Restricted cash**

At September 30, 2003 and December 31, 2002, we had a balance of \$1.5 million in the form of short-term investments, which were restricted from withdrawal. The balance is classified as long-term restricted cash and serves as a security deposit in a post-contract customer support revenue transaction. At September 30, 2003 and December 31, 2002, we also had an interest bearing certificate of deposit classified as short-term investments and restricted cash which serves as collateral for a \$0.4 million letter of credit security deposit for a leased facility.

#### **Stock-based Compensation**

We have adopted the disclosure requirements of Statement of Financial Accounting Standards ("SFAS") No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" during the quarter ended March 31, 2003. SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based compensation and also amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the methods of accounting for stock-based employee compensation and the effect of the method used on reported results. As permitted by SFAS 148 and SFAS 123, we continue to apply the accounting provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." We generally grant stock options at exercise prices equal to the fair market value of the underlying stock on the date of grant and, therefore, under APB Opinion No. 25, no compensation expense is recognized in the statements of operations. Had we recorded compensation expense based on the estimated grant date fair value, as defined by SFAS No. 123, for awards granted under our stock option plans and stock purchase plan, our net loss and loss per share would have been increased to the pro forma amounts below (in thousands, except per share amounts):

Three Months Ended

Nine Months Ended



|  | September<br>30, 2003 | September<br>30, 2002 | September<br>30, 2003 | September<br>30, 2002 |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
| Net loss -- as reported  | \$ (2,129 )           | \$ (4,968 )           | \$ (12,466 )          | \$ (23,725 )          |
| Add: Non-cash compensation expense included in reported net loss       | 489                   | 245                   | 903                   | 939                   |
| Less: Non-cash compensation expense determined under fair value method | (1,425 )              | (3,793 )              | (3,152 )              | (10,835 )             |
| Net loss -- proforma   | \$ (3,065 )           | \$ (8,516 )           | \$ (14,715 )          | \$ (33,621 )          |
| Basic and diluted net loss per share -- as reported                    | \$ (0.04 )            | \$ (0.09 )            | \$ (0.22 )            | \$ (0.43 )            |
| Basic and diluted net loss per share -- proforma                       | \$ (0.05 )            | \$ (0.15 )            | \$ (0.26 )            | \$ (0.61 )            |

### Concentrations of credit risk

Financial instruments that potentially subject us to concentrations of credit risk consist of cash, cash equivalents, short-term investments and accounts receivable. To date, we have invested excess funds in money market accounts, commercial paper, municipal bonds and term notes. We deposit cash, cash equivalents and short-term investments with financial institutions that we believe are credit worthy. Our accounts receivable are derived from revenues earned from customers principally located in the Americas and Europe. We perform ongoing credit evaluations of our customers' financial condition and, generally, we do not require collateral from our customers. We maintain reserves for potential credit losses on customer accounts when deemed necessary.

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The following table summarizes the revenues from customers in excess of 10% of total revenues:

|            | Three Months Ended    |                       | Nine Months Ended  |                    |
|------------|-----------------------|-----------------------|--------------------|--------------------|
|            | September 30,<br>2003 | September 30,<br>2002 | September 30, 2003 | September 30, 2002 |
| Barclays   | --                    | --                    | 10%                | --                 |
| H3G        | --                    | --                    | --                 | 15%                |
| Lloyds TSB | --                    | --                    | --                 | 12%                |
| EDS        | --                    | --                    | --                 | --                 |

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|                                    |     |     |     |     |
|------------------------------------|-----|-----|-----|-----|
| Royal Bank of Scotland             | 22% | --  | 14% | --  |
| USAA                               | --  | 43% | --  | 21% |
| Canadian Imperial Bank of Commerce | 11% | --  | --  | --  |

At September 30, 2003, the total amount due to the Company from Royal Bank of Scotland and Canadian Imperial Bank of Commerce accounted for approximately 22% and 10% of accounts receivable, respectively. At December 31, 2002, the total amount due to the Company from Barclays accounted for approximately 38% of accounts receivable.

### NOTE 3--RECENT ACCOUNTING PRONOUNCEMENTS:

Effective January 1, 2003, we adopted SFAS No. 143, "Accounting for Asset Retirement Obligations," and also SFAS No. 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS No. 143 requires that the fair value of an asset retirement obligation be recorded as a liability in the period in which the Company incurs the obligation. SFAS No. 145 requires that certain gains and losses from extinguishment of debt no longer be classified as an extraordinary item. The adoption of these statements did not have a significant impact on our consolidated financial position or results of operations.

Effective January 1, 2003, we adopted SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 requires that a liability for costs associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. The adoption of this statement did not have a significant impact on our consolidated financial position or results of operations.

Effective January 1, 2003, we adopted SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. Additionally, SFAS No. 148 amends APB Opinion No. 28, "Interim Financial Reporting," and requires disclosure of the pro forma effect in interim financial statements. The transition and annual disclosure requirements of SFAS No. 148 are effective for fiscal years ending after December 15, 2002. The interim disclosure requirements of SFAS No. 148 are effective for interim periods beginning after December 15, 2002 and have been implemented in our financial statements.

In April 2003, the Financial Accounting Standards Board ("FASB") issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities", which amends SFAS No. 133 for certain decisions made by the FASB Derivatives Implementation Group. In particular, SFAS No. 149 (1) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative, (2) clarifies when a derivative contains a financing component, (3) amends the definition of an underlying to conform it to language used in FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, and (4) amends certain other existing pronouncements. This Statement is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. In addition, most provisions of SFAS No. 149 are to be applied prospectively. We do not expect the adoption of SFAS No. 149 to have a material impact upon our financial position or results of operations.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." SFAS No. 150 changes the accounting for certain financial instruments that under previous guidance issuers could account for as equity. It requires that those instruments be classified as liabilities in balance sheets. The guidance in SFAS No. 150 is generally effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective on July 1, 2003. We do not expect the adoption of SFAS No. 150 to have a material impact upon our financial position or results of operations.

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In November 2002, the FASB issued FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN 45 elaborates on the existing disclosure requirements for most guarantees, including residual value

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guarantees issued in conjunction with operating lease agreements. It also clarifies that at the time a company issues a guarantee, the company must recognize an initial liability for the fair value of the obligation it assumes under that guarantee and must disclose that information in its interim and annual financial statements. The initial recognition and measurement provisions of this interpretation apply on a prospective basis to guarantees issued or modified after December 31, 2002. The adoption of FIN 45 did not have a significant impact on our consolidated financial position or results of operations.

In January 2003, the FASB issued FIN 46, "Consolidation of Variable Interest Entities." FIN 46 requires us to consolidate a variable interest entity if we are subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. We do not currently have any variable interest entities and, accordingly, the adoption of FIN 46 did not have a significant impact on our consolidated financial position or results of operations.

### NOTE 4--BALANCE SHEET COMPONENTS (Unaudited):

The main components of accounts receivable, net are as follows (in thousands):

|   | September 30, 2003 | December 31, 2002 |
|---|--------------------|-------------------|
| Accounts receivable, net:                               |                    |                   |
| Accounts receivable                                     | \$ 11,591          | \$ 8,783          |
| Unbilled receivables                                    | 4,582              | 6,741             |
| Allowance for doubtful accounts                         | (156)              | (181)             |
| Accounts receivable included in Other assets, long-term | (791)              | --                |
|   | \$ 15,226          | \$ 15,343         |

Unbilled receivables relate to earned service revenues and licenses delivered that have not yet been billed and maintenance services for future periods that have been purchased by our customers, but have not yet been billed.

The main components of property and equipment, net are as follows (in thousands):

|  | September 30, 2003 | December 31, 2002 |
|--|--------------------|-------------------|
| Property and equipment, net:   |                    |                   |
| Computer hardware (useful lives of 3 years)                          | \$ 11,702          | \$ 11,312         |
| Purchased internal-use software (useful lives of 3 years)            | 2,586              | 2,497             |
| Furniture and equipment (useful lives of 3 to 7 years)               | 1,669              | 1,634             |
| Leasehold improvements (shorter of 7 years or the term of the lease) | 2,782              | 2,840             |
|  | 18,739             | 18,283            |
| Accumulated depreciation and amortization                            | (15,426)           | (13,214)          |
|  | \$ 3,313           | \$ 5,069          |

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The main components of accrued expenses are as follows (in thousands):

|                                      | September 30, 2003 | December 31, 2002 |
|--------------------------------------|--------------------|-------------------|
| Accrued expenses:                    |                    |                   |
| Accrued payroll and related expenses | \$ 6,021           | \$ 8,570          |
| Accrued restructuring expenses       | 3,537              | 4,557             |
| Other accrued liabilities            | 1,769              | 880               |
|                                      | <u>11,327</u>      | <u>14,007</u>     |

The components of intangible assets, excluding goodwill, are as follows (in thousands):

|                        | September 30, 2003    |                          |                     | December 31, 2002     |                          |                     |
|------------------------|-----------------------|--------------------------|---------------------|-----------------------|--------------------------|---------------------|
|                        | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Intangible assets:     |                       |                          |                     |                       |                          |                     |
| Developed technologies | \$ 2,374              | \$ (1,647)               | \$ 727              | \$ 2,374              | \$ (1,059)               | \$ 1,315            |
| Purchased technologies | 7,162                 | (5,839)                  | 1,323               | 7,162                 | (4,050)                  | 3,112               |
| Customer list          | 190                   | (96)                     | 94                  | 190                   | (48)                     | 142                 |
| Tradenames             | 982                   | (822)                    | 160                 | 982                   | (576)                    | 406                 |
|                        | <u>\$ 10,708</u>      | <u>\$ (8,404)</u>        | <u>\$ 2,304</u>     | <u>\$ 10,708</u>      | <u>\$ (5,733)</u>        | <u>\$ 4,975</u>     |

All of our acquired intangible assets, excluding goodwill, are subject to amortization and are carried at cost less accumulated amortization. Amortization is computed over the estimated useful lives which are as follows: Developed technologies-one and one half to three years; purchased technologies-three years; tradenames-three years; customer list-three years. Aggregate amortization expense for intangible assets totaled \$2.7 million for both the nine months ended September 30, 2003 and 2002, respectively. We expect amortization expense on purchased intangible assets to be \$0.9 million for the remaining three months in fiscal 2003, \$1.3 million in fiscal 2004 and \$0.1 million in fiscal 2005, at which time existing purchased intangible assets will be fully amortized.

**NOTE 5--RESTRUCTURING:**

**Restructuring Costs**

During the nine months ended September 30, 2003 and fiscal year 2002, several areas of the Company were restructured to reduce expenses and improve efficiency to achieve cash flow and profitability breakeven in the near future. This restructuring program included a worldwide workforce reduction and consolidation of excess facilities and certain business functions.

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The restructuring program resulted in the reduction of 30 regular employees during the nine months ended September 30, 2003 and 108 regular employees during fiscal year 2002. All areas of the Company were affected by this restructuring. We recorded a total workforce reduction expense relating to severance and benefits of approximately \$1.0 million and \$3.8 million for the nine months ended September 30, 2003 and the year ended December 31, 2002, respectively.

**Consolidation of excess facilities**

We accrued for lease costs of \$0.2 million and \$2.8 million during the nine months ended September 30, 2003 and the year ended December 31, 2002, respectively, pertaining to the estimated future obligations for non-cancelable lease payments for the consolidation of excess facilities relating to lease terminations and non-cancelable lease costs. This expense included estimated sub-lease income based on current comparable rates for leases in the respective markets. If facilities rental rates continue to decrease in these markets or if it takes longer than expected to sublease these facilities, the maximum amount by which the loss could exceed the original estimate is approximately \$1.9 million.

A summary of the restructuring expense and other special charges is outlined as follows (in thousands):

|  | Facilities      | Severance and<br>Benefits | Total           |
|--|-----------------|---------------------------|-----------------|
| <b>Reserve balance at December 31, 2002</b>  | \$ 3,366        | \$ 1,191                  | \$ 4,557        |
| Total expense                                | 202             | 959                       | 1,161           |
| Non-cash                                     | 7               | (130)                     | (123)           |
| Cash paid                                    | (280)           | (1,778)                   | (2,058)         |
| <b>Reserve balance at September 30, 2003</b> | <b>\$ 3,295</b> | <b>\$ 242</b>             | <b>\$ 3,537</b> |

Amounts related to net lease expenses due to the consolidation of facilities will be paid over the lease terms through fiscal 2011. As of September 30, 2003, \$3.5 million related to the restructuring reserve remains outstanding and is included in the accrued expenses line item on the balance sheet. The remaining accrual primarily relates to the termination and/or sublease of our excess facilities and to severance and other benefits for impacted employees.

**NOTE 6--BORROWINGS:**

### Notes payable

Borrowings consist of several notes payable for equipment leases assumed by Chordiant upon the acquisition of OnDemand, Inc. Interest rates range from 12.86% to 15.00%. The notes are due at various times through 2004. As of September 30, 2003, the total outstanding notes payable balance for equipment leases was approximately \$0.2 million.

In February 2003, we entered into a note payable agreement for our Directors' & Officers' ("D&O") insurance policy totaling \$1.0 million. The interest rate is 6% and principal and interest payments on the note payable will be made on a monthly basis through October 2003. As of September 30, 2003, there was no outstanding note payable balance related to the D&O insurance policy.

### Revolving line of credit

Our two-year line of credit with Comerica Bank, effective from March 28, 2003, is comprised of an accounts receivable line and an equipment line.

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Under the line of credit, our assets collateralize borrowings under both elements, require us to maintain a minimum quick ratio of 2.00 to 1.00, a tangible net worth of at least \$15.0 million plus 60% of the proceeds of any equity offerings and subordinated debt issuance subsequent to the effective date of this line of credit agreement, and certain other covenants.

Under the terms and conditions of the accounts receivable line, the total amount of the line of credit is \$7.5 million. Borrowings under the accounts receivable line of credit will bear interest at the lending bank's prime rate plus 0.5%. Advances are available on a non-formula basis up to \$2,000,000 (non-formula portion), however, if outstanding receivables exceed \$2,000,000, then all outstanding receivables shall be covered by 80% of Eligible Accounts.

Borrowings under the \$2.5 million equipment line bear interest at the lending bank's prime rate plus 1.0%. In March 2003, we borrowed \$2.5 million against the equipment line of credit. At September 30, 2003, the outstanding line of credit balance was \$1.9 million. At September 30, 2003, we were in compliance with the respective debt covenants.

We have no material commitments for capital expenditures or strategic commitments and we anticipate a low rate of capital expenditures. We may use cash to acquire or license technology, products or businesses related to our current business. In addition, we anticipate that we will experience low growth in our operating expenses for the foreseeable future and that our operating expenses will continue to be a material use of our cash resources.

### NOTE 7--LITIGATION:

Beginning in July 2001, we and certain of our officers and directors, as well as the underwriters of our initial public offering ("IPO") and hundreds of other companies ("Issuers"), individuals and IPO underwriters, were named as defendants in a series of class action shareholder complaints filed in the United States District Court for the Southern District of New York. Those cases are now consolidated under the caption, *In re Initial Public Offering Securities Litigation*, Case No. 91 MC 92. In the amended complaint against Chordiant, the plaintiffs allege that Chordiant, certain of our officers and directors and our IPO underwriters violated section 11 of the Securities Act of 1933 based on allegations that Chordiant's registration statement and prospectus failed to disclose material facts regarding the compensation to be received by, and the stock allocation practices of, the IPO underwriters. The complaint also contains a claim for violation of section 10(b) of the Securities Exchange Act of 1934 based on allegations that this omission constituted a deceit on investors. The plaintiffs seek unspecified monetary damages and other relief. In October 2002, the parties agreed to toll the statute of limitations with respect to Chordiant's officers and directors until September 30, 2003, and on the basis of this agreement, our officers and directors were dismissed from the lawsuit without prejudice. In February 2003, the

court issued a decision denying the motion to dismiss the Section 11 claims against Chordiant and almost all of the other company defendants and denying the motion to dismiss the Section 10(b) claims against Chordiant and many of the company defendants. In June 2003, Issuers and Plaintiffs reached a tentative settlement agreement that would, among other things, result in the dismissal with prejudice of all claims against the Issuers and their officers and directors in the IPO Lawsuits. In addition, the tentative settlement guarantees that, in the event that the Plaintiffs recover less than \$1 billion in settlement or judgment against the Underwriter defendants in the IPO Lawsuits, the Plaintiffs will be entitled to recover the difference between the actual recovery and \$1 billion from the insurers for the Issuers. Although Chordiant has approved this settlement proposal in principle, it remains subject to a number of procedural conditions, as well as formal approval by the Court. In September 2003, in connection with the possible settlement, those officers and directors who had entered tolling agreements with Plaintiffs (described above) agreed to extend those agreements so that they would not expire prior to any settlement being finalized.

We are also subject to various other claims and legal actions arising in the ordinary course of business. The ultimate disposition of these various other claims and legal actions is not expected to have a material effect on our business, financial condition or results of operations.

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**NOTE 8 --COMMITMENTS AND CONTINGENCIES:**

Future payments due under debt and lease obligations as of September 30, 2003 are as follows (in thousands):

|                                     | <b>Borrowings</b> | <b>Operating<br/>Leases</b> | <b>Sublease<br/>Income</b> | <b>Total</b>     |
|-------------------------------------|-------------------|-----------------------------|----------------------------|------------------|
| Remaining portion<br>of Fiscal 2003 | \$ 258            | \$ 688                      | \$ (143)                   | \$ 803           |
| Fiscal 2004                         | 1,123             | 2,946                       | (438)                      | 3,631            |
| Fiscal 2005                         | 750               | 2,104                       | (143)                      | 2,711            |
| Fiscal 2006                         | --                | 2,258                       | --                         | 2,258            |
| Fiscal 2007                         | --                | 2,224                       | --                         | 2,224            |
| Thereafter                          | --                | 4,664                       | --                         | 4,664            |
| <b>Total</b>                        | <b>\$ 2,131</b>   | <b>\$ 14,884</b>            | <b>\$ (724)</b>            | <b>\$ 16,291</b> |

We have entered into a two-year agreement, beginning March 19, 2002, with Merit International ("Merit"), pursuant to which Merit will provide exclusive training and certain non-exclusive consulting services for a fixed fee. Upon the effective date of the agreement, we transferred to Merit our training operations including selected employees. In addition, Merit will provide to our customers resource development services in exchange for an agreed-upon fee negotiated on a transaction-by-transaction basis. We believe this agreement will provide us with high quality training and consulting services. As part of the original agreement, we were required to pay Merit certain minimum revenue amounts and were subject to an early termination fee. In September 2003, we amended the agreement by extending its effective date through March 2006 and we are no longer required to make minimum revenue payments to Merit or an early termination fee. As part of the amendment, Merit has agreed to share a portion of Merit-Chordiant monthly consulting revenues with us as follows: 0% revenue share of Merit-Chordiant monthly consulting revenues of (British Pounds) 0 to 157,000; 10% revenue share of Merit-Chordiant monthly consulting revenues exceeding (British Pounds) 157,001 and up to 300,000; and 15% revenue share of Merit-Chordiant monthly consulting revenues exceeding (British Pounds) 300,001.

**Indemnifications**

As permitted under Delaware law, we have agreements whereby we indemnify our officers, directors and certain employees for certain events or occurrences while the employee, officer or director is, or was serving, at our request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have a Director and Officer insurance policy that limits our exposure and may enable us to recover a portion of any future amounts paid. As a result of our insurance policy coverage, we believe the estimated fair value of these indemnification agreements is minimal.

We enter into standard indemnification agreements in our ordinary course of business. Pursuant to these agreements, we indemnify, defend, hold harmless, and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally our business partners or customers, in connection with patent, or any copyright or other intellectual property infringement claim by any third party with respect to our products. The term of these indemnification agreements is generally perpetual after execution of the agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. We have never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, we have no liabilities recorded for these agreements as of September 30, 2003.

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We enter into arrangements with our business partners, whereby a business partner agrees to provide services as a subcontractor for our implementations. We may, at our discretion and in the ordinary course of business, subcontract the performance of any of our services. Accordingly, we enter into standard indemnification agreements with our customers, whereby we indemnify them for other acts, such as personal property damage, of our subcontractors. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have general and umbrella insurance policies that may enable us to recover a portion of any amounts paid. We have not incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, we have no liabilities recorded for these agreements as of September 30, 2003.

When as part of an acquisition we acquire all of the stock or all of the assets and liabilities of a company, we may assume the liability for certain events or occurrences that took place prior to the date of acquisition. The maximum potential amount of future payments we could be required to make for such obligations is undeterminable at this time. All of these obligations were grandfathered under the provisions of FIN 45 as they were in effect prior to March 31, 2003. Accordingly, we have no liabilities recorded for these liabilities as of September 30, 2003.

We warrant that our software products will perform in all material respects in accordance with our standard published specifications and documentation in effect at the time of delivery of the licensed products to the customer for a specified period of time. Additionally, we warrant that our maintenance and consulting services will be performed consistent with generally accepted industry standards through completion of the agreed upon services. If necessary, we would provide for the estimated cost of product and service warranties based on specific warranty claims and claim history, however, we have not incurred significant expense under our product or services warranties to date. As a result, we believe the estimated fair value on these warranties is minimal. Accordingly, we have no liabilities recorded for these warranties as of September 30, 2003.

### **NOTE 9--RELATED PARTY TRANSACTIONS:**

During the quarter ended March 31, 2002, two of our executives exercised 285,000 stock options in exchange for notes receivable (the "Notes") of \$496,000. The Notes were full-recourse collateralized by the underlying stock. The Notes were due in February and March of 2003 and accrued interest between 6.0% and 6.5% per annum, which was deemed market rates for the individuals. Both notes were paid in full during the quarter ended March 31, 2003.

### **NOTE 10--NET LOSS PER SHARE:**

Basic and diluted net loss per share is computed by dividing the net loss for the period by the weighted average number of shares of common stock outstanding during the period. The calculation of diluted net loss per share includes potential common stock unless their effect is antidilutive. Potential common stock consist of common shares issuable upon the exercise of stock options (using the treasury stock method) and common shares subject to repurchase by us.

The following table sets forth the computation of basic and diluted net loss per share for the three and nine months ended September 30, 2003 and 2002 (in thousands, except per share data):

|  | Three Months Ended    |                       | Nine Months Ended     |                       |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
|  | September<br>30, 2003 | September<br>30, 2002 | September<br>30, 2003 | September<br>30, 2002 |
|  |                       |                       |                       |                       |



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|   |             |             |              |              |
|---|-------------|-------------|--------------|--------------|
| Net loss available to common stockholders     | \$ (2,129 ) | \$ (4,968 ) | \$ (12,466 ) | \$ (23,725 ) |
| Weighted average common stock outstanding     | 63,661      | 55,552      | 60,951       | 54,731       |
| Common stock subject to repurchase            | (3,624 )    | (5 )        | (3,624 )     | (5 )         |
| Denominator for basic and diluted calculation | 60,037      | 55,547      | 57,327       | 54,726       |
| Net loss per share - basic and diluted        | \$ (0.04 )  | \$ (0.09 )  | \$ (0.22 )   | \$ (0.43 )   |

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The following table sets forth the potential common shares that are excluded from the calculation of diluted net loss per share as their effect is antidilutive (in thousands):

|                                    | Three Months Ended |                    | Nine Months Ended  |                    |
|------------------------------------|--------------------|--------------------|--------------------|--------------------|
|                                    | September 30, 2003 | September 30, 2002 | September 30, 2003 | September 30, 2002 |
| Warrants outstanding               | 1,850              | 1,850              | 1,850              | 1,850              |
| Employee stock options             | 9,711              | 9,237              | 9,711              | 9,237              |
| Common stock subject to repurchase | 3,624              | 5                  | 3,624              | 5                  |
|                                    | 15,185             | 11,092             | 15,185             | 11,092             |

**NOTE 11--COMPREHENSIVE LOSS:**

The components of comprehensive loss, net of tax, are as follows (in thousands):

|  | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2003 | September 30, 2002 | September 30, 2003 | September 30, 2002 |
| Net loss                                 | \$ (2,129)         | \$ (4,968)         | \$ (12,466)        | \$ (23,725)        |
| Other comprehensive income:              |                    |                    |                    |                    |
| Foreign currency translation gain (loss) | 314                | (187)              | 1,261              | 695                |

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|                    |            |            |             |             |
|--------------------|------------|------------|-------------|-------------|
| Comprehensive loss | \$ (1,815) | \$ (5,155) | \$ (11,205) | \$ (23,030) |
|--------------------|------------|------------|-------------|-------------|

For the three and nine months ended September 30, 2003 and 2002, amortized costs of available-for-sale investments approximated their fair values due to their short maturities. As such, unrealized gains or losses on available-for-sale investments were insignificant for the three and nine months ended September 30, 2003 and 2002.

**NOTE 12--SEGMENT INFORMATION:**

Based on the information that our chief operating decision maker reviews for assessing performance and allocating resources, we have concluded that we have one reportable segment.

License revenues for enterprise solutions amounted to \$5.6 million and \$8.0 million for the three months ended September 30, 2003 and 2002, respectively. License revenues for enterprise solutions amounted to \$13.5 million and \$21.8 million for the nine months ended September 30, 2003 and 2002, respectively. License revenues for application products were approximately \$1.0 million and \$0.6 million for the three months ended September 30, 2003 and 2002, respectively. License revenues for application products were approximately \$3.8 million and \$3.9 million for the nine months ended September 30, 2003 and 2002, respectively.

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Service revenues consist of consulting assistance and implementation, customization and integration and post-contract customer support, training and certain reimbursable out-of-pocket expenses. Service revenues for enterprise solutions were approximately \$8.6 million and \$6.8 million for the three months ended September 30, 2003 and 2002, respectively. Service revenues for enterprise solutions were approximately \$23.9 million and \$22.3 million for the nine months ended September 30, 2003 and 2002, respectively. Service revenues for application products were approximately \$2.5 million and \$3.5 million for the three months ended September 30, 2003 and 2002, respectively. Service revenues for application products were approximately \$7.5 million and \$8.7 million for the nine months ended September 30, 2003 and 2002, respectively.

Foreign revenues are based on the country in which the customer is located. The following is a summary of total revenues by geographic area (in thousands):

|                                     | Three Months Ended |                    | Nine Months Ended  |                    |
|-------------------------------------|--------------------|--------------------|--------------------|--------------------|
|                                     | September 30, 2003 | September 30, 2002 | September 30, 2003 | September 30, 2002 |
| Americas                            | \$ 5,085           | \$ 9,902           | \$ 10,181          | \$ 17,099          |
| Europe (principally United Kingdom) | 12,643             | 8,847              | 38,357             | 39,158             |
| Other                               | 38                 | 152                | 128                | 528                |
|                                     | \$ 17,766          | \$ 18,901          | \$ 48,666          | \$ 56,785          |

Property and equipment information is based on the physical location of the assets. The following is a summary of property and equipment, net by geographic area (in thousands):

|          | September 30, 2003 | December 31, 2002 |
|----------|--------------------|-------------------|
| Americas | \$ 1,680           | \$ 2,867          |

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|                                     |          |          |
|-------------------------------------|----------|----------|
| Europe (principally United Kingdom) | 1,633    | 2,198    |
| Other                               | --       | 4        |
|                                     | \$ 3,313 | \$ 5,069 |
|                                     | \$ 3,313 | \$ 5,069 |

### NOTE 13--SUBSEQUENT EVENT:

On October 21, 2003, Steve Vogel announced he was leaving the company after serving approximately two and a half years as Chief Financial Officer and Senior Vice President of Finance effective immediately after the filing of the Company's quarterly report on Form 10-Q for the three and nine months ended September 30, 2003. Concurrent with this announcement, the company announced the appointment of Michael Shannahan as Senior Vice President of Finance commencing October 27, 2003. Mr. Shannahan will assume the position of Chief Financial Officer upon Mr. Vogel's departure.

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## Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This discussion and analysis should be read in conjunction with our financial statements and accompanying notes included in this report and the 2002 audited financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2002. Operating results are not necessarily indicative of results that may occur in future periods.

The following discussion and analysis contains forward-looking statements. These statements are based on our current expectations, assumptions, estimates and projections about our business and our industry, and involve known and unknown risks, uncertainties and other factors that may cause our or our industry's results, levels of activity, performance or achievement to be materially different from any future results, levels of activity, performance or achievements expressed or implied in or contemplated by the forward-looking statements. Words such as "believe," "anticipate," "expect," "intend," "plan," "will," "may," "should," "estimate," "predict," "guidance," "potential," "continue" or the negative of such terms or other similar expressions, identify forward-looking statements. Our actual results and the timing of events may differ significantly from those discussed in the forward-looking statements as a result of various factors, including but not limited to, those discussed under the subheading "Risk Factors" and those discussed elsewhere in this report, in our other SEC filings and in our Annual Report on Form 10-K. Chordiant undertakes no obligation to update any forward-looking statement to reflect events after the date of this report.

### Overview

Chordiant Software, Inc. ("Chordiant", "the Company", or "we") is an enterprise software vendor that offers transactional customer software solutions for global companies that seek to improve the quality of customer interactions and to reduce costs through increased employee productivity and process efficiencies. Chordiant concentrates on serving global customers in retail financial services, communications and consumer direct industries.

We deliver a complete customer system that includes software applications and tools and services that enable businesses to successfully integrate their customer information and corporate systems for an accurate, real-time view of their customers across multiple forms of customer interaction.

We believe our system offers great flexibility to businesses to set business policies and processes to control the quality of servicing, fulfillment and marketing to their customers. Our system enables companies to control and change their business policies and process. We believe that we are leaders in providing business process driven solutions for customer management.

Our software architecture is based on the J2EE (Java 2 Enterprise Edition) industry standard that is widely supported by vendors and widely adopted by business customers in the industries we serve. We believe that solutions based on other architectures are less capable of meeting the current and future requirements of global companies.

We believe that the application of accounting standards is as important as a company's reported financial position, results of operations and cash flows. We believe that our accounting policies are prudent and provide a clear view of our financial performance. We have formed a Disclosure Committee, composed of senior financial and legal personnel, to help ensure the completeness and accuracy of our financial results and

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disclosures. In addition, prior to the release of our financial results, our key management reviews our annual and quarterly results, along with key accounting policies and estimates, with our audit committee, which is composed of independent board members. We do not use off-balance-sheet arrangements with unconsolidated related parties, nor do we use other forms of off-balance-sheet arrangements such as research and development arrangements.

We have completed acquisitions in previous years. As a result of these acquisitions, comparison of prior period revenues and expenses may not be meaningful. One of our business strategies includes pursuing opportunities to grow our business, both through internal growth and through acquisitions of companies, technology and other assets and could include strategic combinations of the Company and other similarly sized or larger companies. To implement this strategy, we may be involved in one or more of these types of transactions in the future.

Service revenues as a percentage of total revenues were 63% and 54% for the three months ended September 30, 2003 and 2002, respectively. Service revenues as a percentage of total revenues were 65% and 55% for the nine months ended September 30, 2003 and 2002, respectively.

We sell our products through our direct sales force, and we augment our sales efforts through relationships with systems integrators, application service providers and technology vendors.

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For the three and nine months ended September 30, 2003 and 2002, revenues were principally derived from customer accounts in the Americas and Europe (principally the United Kingdom). For the three months ended September 30, 2003 and 2002, international revenues were \$12.7 million and \$9.0 million, or approximately 71% and 48% of our total revenues, respectively. For the nine months ended September 30, 2003 and 2002, international revenues were \$38.5 million and \$39.7 million, or approximately 79% and 70% of our total revenues, respectively. We believe international revenues will continue to represent a significant portion of our total revenues in future periods.

A small number of customers account for a significant portion of our total revenues. As a result, the loss or delay of individual orders or delays in the product implementations for a customer can have a material impact on our revenues. We expect that revenues from a small number of customers will continue to account for a majority of our total revenues in the future as historical implementations are completed and replaced with new projects from new and existing customers. Customer concentration has reduced and we expect that trend to continue.

Pricing pressure during the past year has intensified particularly with application products. Several of our competitors continue to aggressively price their products with large discounts in comparison to our prices. Our strategy is to continue to offer products with functionality that is different and superior to our competitors.

Our international revenue has continued to outpace our United States revenue. We feel this has occurred because our leadership and market presence has been very strong internationally, particularly in the United Kingdom.

We have experienced a lengthening of our customers' contract cycle and have adjusted our forecasting model accordingly. We expect this trend to continue so long as the economic environment for enterprise software remains weak.

Since our inception, we have incurred substantial research and development costs and have invested heavily in the expansion of our product development, sales, marketing and professional services organizations in order to build an infrastructure to support our long-term growth strategy. The number of our full-time employees decreased from 328 at December 31, 2002, to 282 at September 30, 2003, representing a decrease of approximately 14%.

In April 2003, we implemented a workforce reduction intended to align our cost base with our expected operating performance. The restructuring charge for the nine months ended September 30, 2003 was \$1.2 million. The restructuring charge is comprised of severance and associated employee termination costs and accruals for lease costs pertaining to the estimated future obligations for non-cancelable lease payments for additional excess facilities that were vacated due to reductions in workforce. As we continue to monitor our operating expenses and strategize for the future, further expense reductions may become necessary to improve operating performance, including further reductions of our workforce in nonperforming regions or outsourcing to companies located in foreign jurisdictions.

Because the restructuring charge and related benefits are derived from management's estimates, which are based on currently available information, our restructuring may not achieve the benefits currently anticipated or on the timetable or at the level, currently contemplated. In addition, our software license revenues and operating performance may continue to be negatively impacted by: (i) the uncertainty in the information technology industry and associated reductions in capital expenditures; (ii) geopolitical uncertainties; (iii) additional terrorist attacks; (iv) a lack of confidence in corporate governance and accounting practices; (v) the diversity in global economic conditions; (vi) continued intense competition; (vii) business and chief executive officer confidence in the economy; and (viii) other factors described under "Risk Factors"

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below. Accordingly, additional actions, including a further restructuring of our operations, may be required in the future. As a result, the demand for our products and services and, ultimately, our future financial performance, are difficult to predict with any degree of certainty.

We believe that period-to-period comparisons of our operating results should not be relied upon as indicative of future performance. Our prospects must be considered given the risks, expenses and difficulties frequently encountered by companies in early stages of development, particularly companies in new and rapidly evolving businesses. There can be no assurance we will be successful in addressing these risks and difficulties. Moreover, we may not achieve or maintain profitability in the future.

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**Results of Operations**

The following table sets forth, as a percentage of total revenues, condensed consolidated statements of operations data for the periods indicated:

|  | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2003 | September 30, 2002 | September 30, 2003 | September 30, 2002 |
| Revenues:                              |                    |                    |                    |                    |
| License                                | 37%                | 46%                | 35%                | 45%                |
| Service                                | 63                 | 54                 | 65                 | 55                 |
| Total revenues                         | 100                | 100                | 100                | 100                |
| Cost of revenues:                      |                    |                    |                    |                    |
| License                                | 2                  | 1                  | 2                  | 2                  |
| Service                                | 36                 | 37                 | 38                 | 41                 |
| Non-cash compensation expense          | 2                  | --                 | 2                  | --                 |
| Total cost of revenues                 | 40                 | 38                 | 42                 | 43                 |
| Gross profit                           | 60                 | 62                 | 58                 | 57                 |
| Operating expenses:                    |                    |                    |                    |                    |
| Sales and marketing:                   |                    |                    |                    |                    |
| Non-cash compensation expense          | 2                  | 1                  | 2                  | 1                  |
| Other sales and marketing expense      | 28                 | 40                 | 32                 | 44                 |
| Research and development:              |                    |                    |                    |                    |
| Non-cash compensation expense          | 2                  | 1                  | 3                  | 1                  |
| Other research and development expense | 23                 | 28                 | 25                 | 27                 |

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|   |              |              |              |              |
|---|--------------|--------------|--------------|--------------|
| Purchased in-process research and development | --           | --           | --           | 2            |
| General and administrative:                   |              |              |              |              |
| Non-cash compensation expense                 | 4            | --           | 3            | --           |
| Other general and administrative expense      | 8            | 13           | 10           | 11           |
| Amortization of intangible assets             | 5            | 5            | 6            | 5            |
| Restructuring expense                         | --           | 1            | 2            | 8            |
| <b>Total operating expenses</b>               | <b>72</b>    | <b>89</b>    | <b>83</b>    | <b>99</b>    |
| <b>Loss from operations</b>                   | <b>(12)</b>  | <b>(27)</b>  | <b>(25)</b>  | <b>(42)</b>  |
| Interest expense                              | --           | --           | --           | --           |
| Other income (expense), net                   | --           | 1            | (1)          | 1            |
| <b>Net loss</b>                               | <b>(12)%</b> | <b>(26)%</b> | <b>(26)%</b> | <b>(41)%</b> |

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## Comparison of the Three Months Ended September 30, 2003 and 2002

### Revenues

*License.* Total license revenues decreased to \$6.6 million for the quarter ended September 30, 2003 from \$8.6 million, or approximately 23%, for the quarter ended September 30, 2002. License revenues for enterprise solutions decreased to \$5.6 million for the quarter ended September 30, 2003 from \$8.0 million, or approximately 29%, for the quarter ended September 30, 2002. License revenues for application products increased to \$1.0 million for the quarter ended September 30, 2003 from \$0.6 million, or approximately 45%, for the quarter ended September 30, 2002. The overall license revenue decrease was primarily due to smaller aggregate dollar sales to new and existing customers for our enterprise solutions.

*Service.* Total service revenues, including reimbursement of out-of-pocket expenses, increased to \$11.1 million for the quarter ended September 30, 2003 from \$10.3 million, or approximately 8%, for the quarter ended September 30, 2002. Service revenues for enterprise solutions increased to \$8.6 million for the quarter ended September 30, 2003 from \$6.8 million, or approximately 28%, for the quarter ended September 30, 2002. Service revenues for application products decreased to \$2.5 million for the quarter ended September 30, 2003 from \$3.5 million, or approximately 29%, for the quarter ended September 30, 2002. The overall service revenues increase was primarily due to a continuation in large customer implementations as well as maintenance, support and consulting revenues associated with license agreements.

### Cost of revenues

*License.* Cost of license revenues increased to \$0.3 million for the quarter ended September 30, 2003 from \$0.2 million, or approximately 64%, for the quarter ended September 30, 2002. These costs resulted in license gross margins of approximately 96% and 98% for the quarters ended September 30, 2003 and 2002, respectively. The cost of license revenues reflects a higher royalty mix in the quarter ended September 30, 2003. We expect cost of license revenues to remain in the four to six percent range of license revenues.

*Service.* Cost of service revenues decreased to \$6.7 million for the quarter ended September 30, 2003 from \$7.1 million, or approximately 5%, for the quarter ended September 30, 2002. These costs resulted in service gross margins of 39% and 31% for the quarters ended September 30, 2003 and 2002, respectively. Service gross margins improved mainly as the result of combined effects of restructuring actions implemented, increased efficiencies and reduced spending.

### ***Operating Expenses***

*Sales and marketing.* Sales and marketing expenses decreased to \$5.3 million for the quarter ended September 30, 2003 from \$7.7 million, or approximately 31%, for the quarter ended September 30, 2002. The decrease in these expenses was mainly attributable to a decrease of \$1.8 million in personnel related expenses due to a decrease in headcount and commission expenses, a decrease of \$0.3 million in marketing programs and trade shows and a decrease of approximately \$0.5 million in office, facilities, depreciation and other related expenses due to restructuring actions implemented. These decreases are partially offset by an increase of approximately \$0.2 million of non-cash compensation expense.

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*Research and development.* Research and development expenses decreased to \$4.5 million for the quarter ended September 30, 2003 from \$5.5 million, or approximately 18%, for the quarter ended September 30, 2002. The decrease in these expenses was mainly attributable to a decrease of \$0.8 million in personnel related expenses due to a decrease in headcount and a decrease of approximately \$0.4 million in office, facilities and depreciation related expenses due to restructuring actions implemented. These decreases were partially offset by an increase of \$0.2 million of non-cash compensation expense.

*Purchased in-process research and development.* In-process research and development expense represents technology acquired that on the date of acquisition, the technology had not achieved technological feasibility and there was no alternative future use based on the state of development. Because the product under development may not achieve commercial viability, the amount of acquired in-process research and development was immediately expensed. The nature of the efforts required to develop the purchased in-process research and development into a commercially viable product principally relate to the completion of all planning, designing, prototyping, verification and testing activities that are necessary to establish that the product can be produced to meet its designed specifications, including functions, features and technical performance requirements. During both the quarters ended September 30, 2003 and 2002, there were no expenses related to purchased in-process research and development.

*General and administrative.* General and administrative expenses decreased to \$2.1 million for the quarter ended September 30, 2003 from \$2.4 million, or approximately 12%, for the quarter ended September 30, 2002. The decrease in these expenses was mainly attributable to a decrease of \$0.7 million in personnel related expenses due to a decrease in headcount, a decrease of \$0.1 million in office, facilities and depreciation related expenses due to restructuring actions implemented and a decrease of \$0.1 million in professional services and other expenses. These decreases were partially offset by an increase of approximately \$0.5 million of non-cash compensation expense primarily related to vesting of restricted stock.

*Amortization of intangibles.* Amortization of intangibles was \$0.9 million for the quarter ended September 30, 2003 compared to \$1.0 million for the quarter ended September 30, 2002.

*Restructuring expenses.* Restructuring expenses were none and \$0.2 million for the three months ended September 30, 2003 and 2002, respectively. All areas of the Company were affected by the restructuring in the three months ended September 30, 2002 which resulted in the reduction of 19 regular employees. The restructuring was part of the Company's continued efforts to reduce expenses and improve efficiency to achieve cash flow and profitability breakeven in the near future.

*Non-cash compensation expense.* We recorded amortization of stock-based compensation expense of \$0.2 million for the quarter ended September 30, 2003 compared to \$0.4 million for the quarter ended September 30, 2002 in relation to options granted prior to our initial public offering with an exercise price lower than the deemed fair market value of the underlying common stock at the date of issuance. At September 30, 2003, approximately \$0.4 million of stock-based compensation remained to be amortized.

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On August 23, 2002, we implemented a stock option exchange program (the "Program"). Under the Program, holders of outstanding options with an exercise price of \$3.00 or greater per share (the "Eligible Options") were given the choice of retaining these options or canceling the options in exchange for (i) restricted shares of common stock ("Restricted Stock") to be issued as soon as possible after the expiration of the Program period and/or (ii) replacement options issuable six (6) months and one (1) day following the cancellation of the Program at the closing market price on that date. On October 4, 2002, we amended the Program to provide the Chief Executive Officer and Chief Financial Officer of the Company, if they participated in the Program, with a Separate Restricted Stock Agreement (the "CEO and CFO Agreement"), which includes specific vesting provisions based on achieving certain financial performance goals. 11,668,875 options were subject to the Program, which closed on October 9, 2002.

Employees tendered 8,109,640 stock options and received 2,780,967 shares of Restricted Stock pursuant to the Program. In addition, employees tendered 672,948 stock options, which were cancelled and to the extent an employee was still with the Company were replaced six (6) months and one (1) day following expiration of the Program. The tendered stock options represented approximately 59% of our total outstanding stock options as of the expiration date of the Program.

In addition, in October 2002, we issued 3,706,745 shares of Restricted Stock to our employees residing in the United Kingdom, including to our Chief Executive Officer. The Restricted Stock issued to our Chief Executive Officer is subject to the CEO and CFO Agreement.

The Program has been accounted for under the guidance of Emerging Issues Task Force Issue No. 00-23 "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25" and Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation - an Interpretation of APB Opinion No. 25." Because we offered to cancel existing fixed stock options in exchange for a grant of restricted stock within six months of the cancellation date of the existing options, the Eligible Options became subject to variable accounting treatment at the commencement date of the Program. Variable accounting ceased upon cancellation of the tendered options. A total of 2,886,287 Eligible Options that were not tendered will remain subject to variable accounting. We recorded \$6.1 million of unearned stock-based compensation expense based on the fair market value of the Restricted Stock at the date of issuance. For the quarter ended September 30, 2003, \$1.5 million was recorded as stock-based compensation expense. The compensation expense on variable options will be re-measured at the end of each operating period until the options are exercised, forfeited or have expired. Depending upon movements in the market value of our common stock, this accounting treatment may result in significant additional stock-based compensation charges in future periods.

As part of the Program implemented in 2002, we issued 499,068 replacement options at the current market value of \$0.88 per share on April 11, 2003 to employees.

The total stock-based compensation expense by operating classification is described as follows (in thousands):

|                            | Three Months Ended |                    |
|----------------------------|--------------------|--------------------|
|                            | September 30, 2003 | September 30, 2002 |
| Cost of revenues           | \$ 343             | \$ 62              |
| Sales and marketing        | 304                | 77                 |
| Research and development   | 414                | 212                |
| General and administrative | 675                | 61                 |
| <b>Total</b>               | <b>\$ 1,736</b>    | <b>\$ 412</b>      |



***Other Income (Expense), net, and Interest Expense***

Interest and other income, net, consist primarily of interest income generated from our cash, cash equivalents, short-term investments, foreign currency gains and losses and other non-operating income and expenses. Interest expenses are incurred in connection with outstanding borrowings. Other income (expense), net, decreased to none for the quarter ended September 30, 2003 from \$0.2 million for the quarter ended September 30, 2002. The decrease is mainly attributable to a lower return on our investments as a result of declining investment balances and lower interest rates and an asset write-off of disposed property and equipment.

**Provision for Income Taxes**

We have not generated taxable income since inception and, as a result, no provision for income taxes was recorded during the periods presented. Our deferred tax assets primarily consist of net operating loss carryforwards, nondeductible allowances and research and development tax credits. We have recorded a valuation allowance for the full amount of our net deferred tax assets, as the future realization of the tax benefit is not considered by management to be more-likely-than-not.

**Comparison of the Nine Months Ended September 30, 2003 and 2002**

***Revenues***

*License.* Total license revenues decreased to \$17.3 million for the nine months ended September 30, 2003 from \$25.7 million, or approximately 33%, for the nine months ended September 30, 2002. License revenues for enterprise solutions decreased to \$13.5 million for the nine months ended September 30, 2003 from \$21.8 million, or approximately 38%, for the nine months ended September 30, 2002. License revenues for application products decreased to \$3.8 million for the nine months ended September 30, 2003 from \$3.9 million, or approximately 5%, for the nine months ended September 30, 2002. The overall license revenue decrease was primarily due to the lack of growth in the number of product implementations and smaller aggregate dollar sales by new and existing customers as they reduced or delayed spending.

*Service.* Total service revenues, including reimbursement of out-of-pocket expenses, increased to \$31.4 million for the nine months ended September 30, 2003 from \$31.0 million, or approximately 1%, for the nine months ended September 30, 2002. Service revenues for enterprise solutions increased to \$23.9 million for the nine months ended September 30, 2003 from \$22.3 million, or approximately 7%, for the nine months ended September 30, 2002. Service revenues for application products decreased to \$7.5 million for the nine months ended September 30, 2003 from \$8.7 million, or approximately 13%, for the nine months ended September 30, 2002. The overall service revenues increase was primarily due to a continuation in large customer implementations as well as maintenance, support and consulting revenues associated with license agreements.

***Cost of revenues***

*License.* Cost of license revenues decreased to \$0.8 million for the nine months ended September 30, 2003 from \$1.2 million, or approximately 30%, for the nine months ended September 30, 2002. These costs resulted in license gross margins of approximately 95% for both the nine months ended September 30, 2003 and 2002, respectively. The aggregate cost of license revenues is in line with the decrease in aggregate license revenues. We expect cost of license revenues to remain in the four to six percent range of license revenues.

*Service.* Cost of service revenues decreased to \$19.5 million for the nine months ended September 30, 2003 from \$23.4 million, or approximately 17%, for the nine months ended September 30, 2002. These costs resulted in service gross margins of 38% and 25% for the nine months ended September 30, 2003 and 2002, respectively. Service gross margins improved mainly as the result of combined effects of restructuring actions implemented, increased efficiencies and reduced spending.

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***Operating Expenses***

*Sales and marketing.* Sales and marketing expenses decreased to \$16.7 million for the nine months ended September 30, 2003 from \$25.4 million, or approximately 34%, for the nine months ended September 30, 2002. The decrease in these expenses was mainly attributable to a decrease of \$6.1 million in personnel related expenses due to a decrease in headcount and commission expenses, a decrease of \$2.2 million in marketing programs, trade shows and professional services and a decrease of approximately \$1.1 million in office, facilities, depreciation and other related expenses due to restructuring actions implemented. These decreases are partially offset by an increase of \$0.7 million of non-cash compensation expense.

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*Research and development.* Research and development expenses decreased to \$13.4 million for the nine months ended September 30, 2003 from \$16.0 million, or approximately 16%, for the nine months ended September 30, 2002. The decrease in these expenses was mainly attributable to a decrease of \$2.3 million in personnel related expenses due to a decrease in headcount and bonus expenses and a decrease of approximately \$1.1 million in overhead allocations, office, facilities and depreciation related expenses due to restructuring actions implemented. These decreases are partially offset by an increase of \$0.7 million of non-cash compensation expense.

*Purchased in-process research and development.* In-process research and development expense represents technology acquired that on the date of acquisition, the technology had not achieved technological feasibility and there was no alternative future use based on the state of development. Because the product under development may not achieve commercial viability, the amount of acquired in-process research and development was immediately expensed. The nature of the efforts required to develop the purchased in-process research and development into a commercially viable product principally relate to the completion of all planning, designing, prototyping, verification and testing activities that are necessary to establish that the product can be produced to meet its designed specifications, including functions, features and technical performance requirements. During the nine months ended September 30, 2003, there were no expenses related to purchased in-process research and development. Purchased in-process research and development of \$1.0 million for the nine months ended September 30, 2002 is related to the OnDemand, Inc. acquisition that was completed on April 1, 2002.

*General and administrative.* General and administrative expenses decreased to \$6.6 million for the nine months ended September 30, 2003 from \$6.7 million, or approximately 1%, for the nine months ended September 30, 2002. The decrease in these expenses was mainly attributable to a decrease of \$1.2 million in personnel related expenses due to a decrease in headcount, a decrease of \$0.1 million in office, facilities and depreciation related expenses due to restructuring actions implemented and a decrease of \$0.4 million in professional services and other expenses. These decreases were partially offset by an increase of \$1.4 million of non-cash compensation expense primarily related to vesting of restricted stock and an increase of \$0.2 million in state tax related expenses.

*Amortization of intangibles.* Amortization of intangibles was \$2.7 million for both the nine months ended September 30, 2003 and 2002, respectively.

*Restructuring expenses.* During the nine months ended September 30, 2003 and fiscal year 2002, several areas of the Company were restructured to reduce expenses and improve efficiency in order to achieve cash flow and profitability breakeven in the near future. This restructuring program included a worldwide workforce reduction and consolidation of excess facilities and certain business functions.

### Workforce reduction

The restructuring program resulted in the reduction of 30 regular employees during the nine months ended September 30, 2003 and 108 regular employees during fiscal year 2002. All areas of the Company were affected by this restructuring. We recorded a total workforce reduction expense relating to severance and benefits of approximately \$1.0 million and \$3.8 million for the nine months ended September 30, 2003 and the year ended December 31, 2002, respectively.

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#### Consolidation of excess facilities

We accrued for lease costs of \$0.2 million and \$2.8 million during the nine months ended September 30, 2003 and the year ended December 31, 2002, respectively, pertaining to the estimated future obligations for non-cancelable lease payments for the consolidation of excess facilities relating to lease terminations and non-cancelable lease costs. This expense included estimated sub-lease income based on current comparable rates for leases in the respective markets. If facilities rental rates continue to decrease in these markets or if it takes longer than expected to sublease these facilities, the maximum amount by which the loss could exceed the original estimate is approximately \$1.9 million.

A summary of the restructuring expense and other special charges is outlined as follows (in thousands):

|  | Facilities | Severance and<br>Benefits | Total    |
|--|------------|---------------------------|----------|
| <b>Reserve balance at December 31, 2002</b>  | \$ 3,366   | \$ 1,191                  | \$ 4,557 |
| Total expense                                | 202        | 959                       | 1,161    |
| Non-cash                                     | 7          | (130)                     | (123)    |
| Cash paid                                    | (280)      | (1,778)                   | (2,058)  |
| <b>Reserve balance at September 30, 2003</b> | \$ 3,295   | \$ 242                    | \$ 3,537 |

Amounts related to net lease expenses due to the consolidation of facilities will be paid over the lease terms through fiscal 2011. As of September 30, 2003, \$3.5 million related to the restructuring reserve remains outstanding and is included in the accrued expenses line item on the balance sheet. The remaining accrual primarily relates to the termination and/or sublease of our excess facilities and to severance and other benefits for impacted employees.

*Non-cash compensation expense.* We recorded amortization of stock-based compensation expense of \$0.6 million for the nine months ended September 30, 2003 compared to \$1.4 million for the nine months ended September 30, 2002 in relation to options granted prior to our initial public offering with an exercise price lower than the deemed fair market value of the underlying common stock at the date of issuance. At September 30, 2003, approximately \$0.4 million of stock-based compensation remained to be amortized.

On August 23, 2002, we implemented a stock option exchange program (the "Program"). Under the Program, holders of outstanding options with an exercise price of \$3.00 or greater per share (the "Eligible Options") were given the choice of retaining these options or canceling the options in exchange for (i) restricted shares of common stock ("Restricted Stock") to be issued as soon as possible after the expiration of the Program period and/or (ii) replacement options issuable six (6) months and one (1) day following the cancellation of the Program at the closing market price on that date. On October 4, 2002, we amended the Program to provide the Chief Executive Officer and Chief Financial Officer of the Company, if they participated in the Program, with a Separate Restricted Stock Agreement (the "CEO and CFO Agreement"), which includes specific vesting provisions based on achieving certain financial performance goals. 11,668,875 options were subject to the Program, which closed on October 9, 2002.

Employees tendered 8,109,640 stock options and received 2,780,967 shares of Restricted Stock pursuant to the Program. In addition, employees tendered 672,948 stock options, which were cancelled and to the extent an employee was still with the Company were replaced six (6) months and one (1) day following expiration of the Program. The tendered stock options represented approximately 59% of our total outstanding stock options as of the expiration date of the Program.

In addition, in October 2002, we issued 3,706,745 shares of Restricted Stock to our employees residing in the United Kingdom, including to our Chief Executive Officer. The Restricted Stock issued to our Chief Executive Officer is subject to the CEO and CFO Agreement.

The Program has been accounted for under the guidance of Emerging Issues Task Force Issue No. 00-23 "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25" and Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation - an Interpretation of APB Opinion No. 25." Because we offered to cancel existing fixed stock options in exchange for a grant of restricted stock within six months of the cancellation date of the existing options, the Eligible Options became subject to variable accounting treatment at the commencement date of the Program. Variable accounting ceased upon cancellation of the tendered options. A total of 2,886,287 Eligible Options that were not tendered will remain subject to variable accounting. We recorded \$6.1 million of unearned stock-based compensation expense based on the fair market value of the Restricted Stock at the date of issuance. For the nine months ended September 30, 2003, \$4.4 million was recorded as stock-based compensation expense. The compensation expense on variable options will be re-measured at the end of each operating period until the options are exercised, forfeited or have expired. Depending upon movements in the market value of our common stock, this accounting treatment may result in significant additional stock-based compensation charges in future periods.

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As part of the Program implemented in 2002, we issued 499,068 replacement options at the current market value of \$0.88 per share on April 11, 2003 to employees.

The total stock-based compensation expense by operating classification is described as follows (in thousands):

|                            | Nine Months Ended  |                    |
|----------------------------|--------------------|--------------------|
|                            | September 30, 2003 | September 30, 2002 |
| Cost of revenues           | \$ 1,121           | \$ 233             |
| Sales and marketing        | 995                | 313                |
| Research and development   | 1,279              | 602                |
| General and administrative | 1,653              | 222                |
| <b>Total</b>               | <b>\$ 5,048</b>    | <b>\$ 1,370</b>    |

### ***Other Income (Expense), net, and Interest Expense***

Interest and other income, net, consist primarily of interest income generated from our cash, cash equivalents, short-term investments, foreign currency gains and losses and other non-operating income and expenses. Interest expenses are incurred in connection with outstanding borrowings. Other income (expense), net, decreased to \$(0.1) million for the nine months ended September 30, 2003 from \$0.7 million for the nine months ended September 30, 2002. The decrease is mainly attributable to a lower return on our investments as a result of declining investment balances and lower interest rates, the write-off of a long outstanding acquisition-related balance and an asset write-off of disposed property and equipment.

### **Provision for Income Taxes**

We have not generated taxable income since inception and, as a result, no provision for income taxes was recorded during the periods presented. Our deferred tax assets primarily consist of net operating loss carryforwards, nondeductible allowances and research and development tax credits. We have recorded a valuation allowance for the full amount of our net deferred tax assets, as the future realization of the tax benefit is not considered by management to be more-likely-than-not.

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

Our cash, cash equivalents, short-term investments and restricted cash and long-term restricted cash consist principally of money market funds, municipal bonds, and marketable equity securities, which totaled \$34.2 million at September 30, 2003. All of our short-term investments are classified as available-for-sale under the provisions of Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities." The securities are carried at fair market value. Gains and losses on investments are recognized when realized on the consolidated statements of operations.

Cash used in operating activities primarily consists of our net loss adjusted for certain non-cash items including depreciation, amortization, non-cash compensation expense and the effect of changes in assets and liabilities. Cash used in operating activities for the nine months ended September 30, 2003 was \$11.2 million and consisted primarily of our net loss of \$12.5 million adjusted for non-cash items of approximately \$10.0 million and the effect of changes in assets and liabilities of approximately \$8.7 million. The effect of changes in assets and liabilities resulted primarily from an increase other assets of \$0.5 million, a decrease in accounts payable of \$3.1 million, a decrease in accrued expenses of \$2.5 million and a decrease in deferred revenue of \$2.6 million. Cash used in operating activities for the nine months ended September 30, 2002 was \$8.7 million and consisted primarily of our net loss of \$23.7 million adjusted for non-cash items of approximately \$8.5 million and the effect of changes in assets and liabilities of \$6.5 million. The effect of changes in assets and liabilities resulted primarily from a decrease in accounts receivable of \$6.8 million, a decrease in prepaid expenses and other assets of \$2.3 million, an increase in accrued expenses of \$2.1 million and partially offset by a decrease in other liabilities of \$0.8 million and a decrease in deferred revenue of \$3.9 million.

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Cash provided by investing activities for the nine months ended September 30, 2003 was \$8.2 million and consisted primarily of \$8.6 million of proceeds from sales and maturities of short-term investments (net of purchases of short-term investments) and partially offset by approximately \$0.4 million of property and equipment purchases. Cash provided by investing activities for the nine months ended September 30, 2002 was \$6.4 million and consisted primarily of approximately \$12.2 million of proceeds from sales and maturities of short-term investments (net of purchases of short-term investments) and partially offset by \$4.8 million for proceeds used in the acquisition of OnDemand, Inc. (net of cash acquired) and \$1.0 million of property and equipment purchases (net of proceeds from disposal of property and equipment).

Cash provided by financing activities for the nine months ended September 30, 2003 was \$3.0 million and consisted primarily of proceeds from borrowings of \$0.9 million (net of repayment of borrowings), \$1.3 million of proceeds from the issuance of common stock for the employee stock purchase plan, \$0.5 million from the repayment of notes receivable and approximately \$0.3 million of proceeds from the exercise of stock options by employees. Cash provided by financing activities for the nine months ended September 30, 2002 was \$5.4 million and consisted of proceeds from the exercise of stock options of \$1.5 million, proceeds from the issuance of common stock for the employee stock purchase plan of approximately \$1.6 million, proceeds from the sale of 479,100 shares of our common stock to Canadian Imperial Holdings Inc. for an aggregate purchase price of \$3.0 million and partially offset by the repayment of borrowings of \$0.7 million (net of proceeds from borrowings).

At September 30, 2003, we had a balance of \$1.5 million in the form of short-term investments, which were restricted from withdrawal and is now classified as long-term restricted cash on our balance sheet. The balance serves as a security deposit in a revenue transaction. At September 30, 2003 and December 31, 2002, we also had an interest bearing certificate of deposit classified as short-term investments and restricted cash which serves as collateral for a \$0.4 million letter of credit security deposit for a leased facility.

***Notes payable***

Borrowings consist of several notes payable for equipment leases assumed by Chordiant upon the acquisition of OnDemand, Inc. Interest rates range from 12.86% to 15.00%. The notes are due at various times through 2004. As of September 30, 2003, the total outstanding notes payable balance for equipment leases was approximately \$0.2 million.

In February 2003, we entered into a note payable agreement for our Directors' & Officers' ("D&O") insurance policy totaling \$1.0 million. The interest rate is 6% and principal and interest payments on the note payable will be made on a monthly basis through October 2003. As of September 30, 2003, there was no outstanding note payable balance related to the D&O insurance policy .

***Revolving line of credit***

Our two-year line of credit with Comerica Bank, effective from March 28, 2003, is comprised of an accounts receivable line and an equipment line.

Under the line of credit, our assets collateralize borrowings under both elements, and we are required to maintain a minimum quick ratio of 2.00 to 1.00, a tangible net worth of at least \$15.0 million plus 60% of the proceeds of any equity offerings and subordinated debt issuance subsequent to the effective date of this line of credit agreement. Certain other covenants also apply.

Under the terms and conditions of the accounts receivable line, the total amount of the line of credit is \$7.5 million. Borrowings under the accounts receivable line of credit will bear interest at the lending bank's prime rate plus 0.5%. Advances are available on a non-formula basis up to \$2,000,000 (non-formula portion), however, if outstanding receivables exceed \$2,000,000, then all outstanding receivables shall be covered by 80% of Eligible Accounts.

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Borrowings under the \$2.5 million equipment line bear interest at the lending bank's prime rate plus 1.0%. In March 2003, we borrowed \$2.5 million against the equipment line of credit. At September 30, 2003, the outstanding line of credit balance was \$1.9 million. At September 30, 2003, we were in compliance with the respective debt covenants.

We have no material commitments for capital expenditures or strategic commitments and we anticipate a low rate of capital expenditures. We may use cash to acquire or license technology, products or businesses related to our current business. In addition, we anticipate that we will experience low or no growth or a decline in our operating expenses for the foreseeable future and that our operating expenses will continue to be a material use of our cash resources.

### *Future Commitments*

Future payments due under debt and lease obligations as of September 30, 2003 are as follows (in thousands):

|                                     | <b>Borrowings</b> | <b>Operating<br/>Leases</b> | <b>Sublease<br/>Income</b> | <b>Total</b>     |
|-------------------------------------|-------------------|-----------------------------|----------------------------|------------------|
| Remaining portion<br>of Fiscal 2003 | \$ 258            | \$ 688                      | \$ (143)                   | \$ 803           |
| Fiscal 2004                         | 1,123             | 2,946                       | (438)                      | 3,631            |
| Fiscal 2005                         | 750               | 2,104                       | (143)                      | 2,711            |
| Fiscal 2006                         | --                | 2,258                       | --                         | 2,258            |
| Fiscal 2007                         | --                | 2,224                       | --                         | 2,224            |
| Thereafter                          | --                | 4,664                       | --                         | 4,664            |
| <b>Total</b>                        | <b>\$ 2,131</b>   | <b>\$ 14,884</b>            | <b>\$ (724)</b>            | <b>\$ 16,291</b> |

We have entered into a two-year agreement, beginning March 19, 2002, with Merit International ("Merit"), pursuant to which Merit will provide exclusive training and certain non-exclusive consulting services for a fixed fee. Upon the effective date of the agreement, we transferred to Merit our training operations including selected employees. In addition, Merit will provide to our customers resource development services in exchange for an agreed-upon fee negotiated on a transaction-by-transaction basis. We believe this agreement will provide us with high quality training and consulting services. As part of the original agreement, we were required to pay Merit certain minimum revenue amounts and were subject to an early termination fee. In September 2003, we amended the agreement by extending its effective date through March 2006 and we are no longer required to make minimum revenue payments to Merit or an early termination fee. As part of the amendment, Merit has agreed to share a portion of Merit-Chordiant monthly consulting revenues with us as follows: 0% revenue share of Merit-Chordiant monthly consulting revenues of (British Pounds) 0 to 157,000; 10% revenue share of Merit-Chordiant monthly consulting revenues exceeding (British Pounds) 157,001 and up to 300,000; and 15% revenue share of Merit-Chordiant monthly consulting revenues exceeding (British Pounds) 300,001.

### *Subsequent Event*

On October 21, 2003, Steve Vogel announced he was leaving the company after serving approximately two and a half years as Chief Financial Officer and Senior Vice President of Finance effective immediately after the filing of the Company's quarterly report on Form 10-Q for the three and nine months ended September 30, 2003. Concurrent with this announcement, the company announced the appointment of Michael Shannahan as Senior Vice President of Finance commencing October 27, 2003. Mr. Shannahan will assume the position of Chief Financial Officer after Mr. Vogel's departure.

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### **Critical Accounting Policies**

Our 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. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure

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of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to estimates of percentage of completion on our service contracts, uncollectible receivables, investment values, intangible assets, restructuring costs and contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be 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 under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our condensed consolidated financial statements:

- \* Revenue recognition, including estimating the total estimated days to complete sales arrangements involving significant implementation or customization essential to the functionality of our product;
- \* Estimating valuation allowances and accrued liabilities, specifically the allowance for doubtful accounts, and assessment of the probability of the outcome of our current litigation;
- \* Restructuring costs; and
- \* Determining functional currencies for the purposes of consolidating our international operations.

### ***Revenue recognition***

We derive revenues from licenses of our software and related services, which include assistance in implementation, customization and integration, post-contract customer support, training and consulting. In addition to determining our results of operations for a given period, our revenue recognition determines the timing of certain expenses, such as sales commissions and royalties. Revenue recognition rules for software companies are very complex and certain judgments affect the application of our revenue policy. The amount and timing of our revenue is difficult to predict and any shortfall in revenue or delay in recognizing revenue could cause our operating results to vary significantly from quarter to quarter and could result in operating losses.

At the time of entering into a transaction, we assess whether any services included within the arrangement require us to perform significant implementation or customization essential to the functionality of our products. For contracts involving significant implementation or customization essential to the functionality of our products, we recognize the license and professional consulting services revenues using the percentage-of-completion method using labor hours incurred as the measure of progress towards completion as prescribed by Statement of Position ("SOP") No. 81-1, "Accounting for Performance of Construction-Type and Certain Product-Type Contracts." The progress toward completion is measured based on the "go-live date." We define the "go-live date" as the date on which the essential product functionality has been delivered or on which the application enters into a production environment or the point at which no significant additional Chordiant supplied professional services resources are required. Estimates are subject to revisions as the contract progresses to completion. We account for the change in estimate in the period the change has been identified. Provisions for estimated contract losses are recognized in the period in which the loss becomes probable and can be reasonably estimated. When we sell additional licenses related to the original licensing agreement, revenue is recognized either upon delivery if the project has reached the go-live date or if the project has not reached the go-live date under the percentage of completion method. We classify revenues from these arrangements as license and service revenues based upon the estimated fair value of each element.

On contracts for products not involving significant implementation or customization essential to the product functionality, we recognize license revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, collection of the fee is probable and delivery has occurred as prescribed by SOP No. 97-2, "Software Revenue Recognition."

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We assess collection based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. We do not request collateral from our customers. If we determine that collection of a fee is not probable, we defer the fee and recognize revenue at the time collection becomes probable, which is generally upon receipt of cash.

For arrangements with multiple elements, we recognize revenue for services and post-contract customer support based upon vendor specific objective evidence ("VSOE") of fair value of the respective elements. VSOE of fair value for the services element is based upon the standard hourly rates we charge for services when such services are sold separately. VSOE of fair value for annual post-contract customer support is established with the optional stated future renewal rates included in the contracts. When contracts contain multiple elements, and VSOE of fair value exists for all undelivered elements, we account for the delivered elements, principally the license portion, based upon the "residual method" as prescribed by SOP No. 98-9, "Modification of SOP No. 97-2 with Respect to Certain Transactions."

In situations in which we are obligated to provide unspecified additional software products in the future, we recognize revenue as a subscription ratably over the term of the commitment period.

For all sales we use either a binding purchase order or signed license agreement as evidence of an arrangement. Sales through our third party systems integrators are evidenced by a master agreement governing the relationship together with binding purchase orders on a transaction-by-transaction basis. Revenues from reseller arrangements are recognized on the "sell-through" method, when the reseller reports to us the sale of our software products to end-users. Our agreements with customers and resellers do not contain product return rights.

We recognize revenue for post-contract customer support ratably over the support period, generally one year. Our training and consulting services revenues are recognized as such services are performed.

### ***Allowance for doubtful accounts and accruals for litigation***

We must make estimates of the uncollectability of our accounts receivables. We specifically analyze accounts receivable and analyze historical bad debts, customer concentrations, customer credit-worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. Generally, we require no collateral from our customers. Our accounts receivable balance was \$15.2 million, net of allowance for doubtful accounts of \$0.2 million and long-term accounts receivable included in Other assets of \$0.8 million as of September 30, 2003. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances would be required.

Our current estimated range of liability related to some of the pending litigation is based on claims for which we can estimate the amount and range of loss. We have recorded at least the minimum estimated liability related to those claims, when there is a range of loss. Because of the uncertainties related to both the amount and range of loss on the remaining pending litigation, we are unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, we will assess the potential liability related to our pending litigation and revise our estimates. Such revisions in our estimates could materially impact our results of operations and financial position.

### ***Restructuring costs***

During the quarter ended June 30, 2003 and fiscal 2002, we implemented cost-reduction plans as part of our continued effort to streamline our operations to reduce ongoing operating expenses. These plans resulted in restructuring charges related to, among others, the consolidation of excess facilities. These charges relate to facilities and portions of facilities we no longer utilize and either seek to terminate early or sublease. Lease termination costs for the abandoned facilities were estimated for the remaining lease obligations and brokerage fees offset by estimated sublease income. Estimates related to sublease costs and income are based on assumptions regarding the period required to locate and contract with suitable sub-lessees and sublease rates which can be achieved using market trend information analyses provided by a commercial real estate brokerage retained by us. Each reporting period we review these estimates and to the extent that these assumptions change due to continued negotiations with landlords or changes in the market, the ultimate restructuring expenses for these abandoned facilities could vary by material amounts.



*Determining functional currencies for the purpose of consolidation*

We have several foreign subsidiaries which together accounted for approximately 79% of our revenues, 48% of our assets and 65% of our total liabilities as of and for the nine months ended September 30, 2003.

In preparing our condensed consolidated financial statements, we are required to translate the financial statements of the foreign subsidiaries from the currency in which they keep their accounting records, generally the local currency, into United States dollars. This process results in exchange gains and losses which, under the relevant accounting guidance are either included within the statement of operations or as a separate part of our net equity under the caption "cumulative translation adjustment."

Under the relevant accounting guidance the treatment of these translation gains or losses is dependent upon our management's determination of the functional currency of each subsidiary. The functional currency is determined based on management judgment and involves consideration of all relevant economic facts and circumstances affecting the subsidiary. Generally, the currency in which the subsidiary transacts a majority of its transactions, including billings, financing, payroll and other expenditures would be considered the functional currency but any dependency upon the parent and the nature of the subsidiary's operations must also be considered.

If any subsidiary's functional currency is deemed to be the local currency, then any gain or loss associated with the translation of that subsidiary's financial statements is included in cumulative translation adjustments. However, if the functional currency were deemed to be the United States dollar then any gain or loss associated with the translation of these financial statements would be included within our statement of operations. If we dispose of any of our subsidiaries, any cumulative translation gains or losses would be realized into our statement of operations. If we determine that there has been a change in the functional currency of a subsidiary to the United States dollar, any translation gains or losses arising after the date of change would be included within our statement of operations.

Based on our assessment of the factors discussed above, we consider the relevant subsidiary's local currency to be the functional currency for each of our international subsidiaries. Accordingly, we had cumulative translation gains of approximately \$1.3 million which were included as part of accumulated other comprehensive income within our balance sheet at September 30, 2003.

The magnitude of these gains or losses is dependent upon movements in the exchange rates of the foreign currencies in which we transact business against the United States dollar. These currencies include the United Kingdom Pound Sterling, the Euro and Australian and Canadian Dollars. Any future translation gains or losses could be significantly higher than those noted in each of these years. In addition, if we determine that a change in the functional currency of one of our subsidiaries has occurred at any point in time we would be required to include any translation gains or losses from the date of change in our statement of operations.

### Recent Accounting Pronouncements

Effective January 1, 2003, we adopted SFAS No. 143, "Accounting for Asset Retirement Obligations," and also SFAS No. 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS No. 143 requires that the fair value of an asset retirement obligation be recorded as a liability in the period in which the Company incurs the obligation. SFAS No. 145 requires that certain gains and losses from extinguishment of debt no longer be classified as an extraordinary item. The adoption of these statements did not have a significant impact on our consolidated financial position or results of operations.

Effective January 1, 2003, we adopted SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 requires that a liability for costs associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. The adoption of this statement did not have a significant impact on our consolidated financial position or results of operations.

Effective January 1, 2003, we adopted SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. Additionally, SFAS No. 148 amends APB Opinion No. 28, "Interim Financial Reporting," and requires disclosure of the pro forma effect in interim financial statements. The transition and annual disclosure requirements of SFAS No. 148 are effective for fiscal years ending after December 15, 2002. The interim disclosure requirements of SFAS No. 148 are effective for interim periods beginning after December 15, 2002 and have been implemented in our financial statements.

In April 2003, the Financial Accounting Standards Board ("FASB") issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities", which amends SFAS No. 133 for certain decisions made by the FASB Derivatives Implementation Group. In particular, SFAS No. 149 (1) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative, (2) clarifies when a derivative contains a financing component, (3) amends the definition of an underlying to conform it to language used in FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, and (4) amends certain other existing pronouncements. This Statement is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. In addition, most provisions of SFAS No. 149 are to be applied prospectively. We do not expect the adoption of SFAS No. 149 to have a material impact upon our financial position or results of operations.

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In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." SFAS No. 150 changes the accounting for certain financial instruments that under previous guidance issuers could account for as equity. It requires that those instruments be classified as liabilities in balance sheets. The guidance in SFAS No. 150 is generally effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective on July 1, 2003. We do not expect the adoption of SFAS No. 150 to have a material impact upon our financial position or results of operations.

In November 2002, the FASB issued FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN 45 elaborates on the existing disclosure requirements for most guarantees, including residual value guarantees issued in conjunction with operating lease agreements. It also clarifies that at the time a company issues a guarantee, the company must recognize an initial liability for the fair value of the obligation it assumes under that guarantee and must disclose that information in its interim and annual financial statements. The initial recognition and measurement provisions of this interpretation apply on a prospective basis to guarantees issued or modified after December 31, 2002. The adoption of FIN 45 did not have a significant impact on our consolidated financial position or results of operations.

As permitted under Delaware law, we have agreements whereby we indemnify our officers, directors and certain employees for certain events or occurrences while the employee, officer or director is, or was serving, at our request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have a Director and Officer insurance policy that limits our exposure and may enable us to recover a portion of any future amounts paid. As a result of our insurance policy coverage, we believe the estimated fair value of these indemnification agreements is minimal.

We enter into standard indemnification agreements in our ordinary course of business. Pursuant to these agreements, we indemnify, defend, hold harmless, and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally our business partners or customers, in connection with patent, or any copyright or other intellectual property infringement claim by any third party with respect to our products. The term of these indemnification agreements is generally perpetual after execution of the agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. We have never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, we have no liabilities recorded for these agreements as of September 30, 2003.

We enter into arrangements with our business partners, whereby the business partner agrees to provide services as a subcontractor for our implementations. We may, at our discretion and in the ordinary course of business, subcontract the performance of any of our services. Accordingly, we enter into standard indemnification agreements with our customers, whereby we indemnify them for other acts, such as personal property damage, of our subcontractors. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have general and umbrella insurance policies that may enable us to recover a portion of any amounts paid. We have not incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, we have no liabilities recorded for these agreements as of September 30, 2003.

When as part of an acquisition we acquire all of the stock or all of the assets and liabilities of a company, we may assume the liability for certain events or occurrences that took place prior to the date of acquisition. The maximum potential amount of future payments we could be required to make for such obligations is undeterminable at this time. All of these obligations were grandfathered under the provisions of FIN 45 as they were in effect prior to March 31, 2003. Accordingly, we have no liabilities recorded for these liabilities as of September 30, 2003.

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We warrant that our software products will perform in all material respects in accordance with our standard published specifications and documentation in effect at the time of delivery of the licensed products to the customer for a specified period of time. Additionally, we warrant that our maintenance and consulting services will be performed consistent with generally accepted industry standards through completion of the agreed upon services. If necessary, we would provide for the estimated cost of product and service warranties based on specific warranty claims and claim history, however, we have not incurred significant expense under our product or services warranties to date. As a result, we believe the estimated fair value on these warranties is minimal. Accordingly, we have no liabilities recorded for these warranties as of September 30, 2003.

In January 2003, the FASB issued FIN 46, "Consolidation of Variable Interest Entities." FIN 46 requires us to consolidate a variable interest entity if we are subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. We do not currently have any variable interest entities and, accordingly, the adoption of FIN 46 did not have a significant impact on our consolidated financial position or results of operations.

## RISK FACTORS

Weakness in technology spending in our target markets combined with geopolitical concerns, vendor viability concerns and our limited resources may make the closing of large license transactions to new and existing customers difficult.

Our revenues fell in the nine months ended September 30, 2003 compared to revenues for the nine months ended September 30, 2002. Our revenues will continue to decrease in 2003 if we are unable to enter into new large-scale license transactions with new and existing customers. The current state of world affairs and geopolitical concerns have left many customers reluctant to enter into new license transactions without some assurance that the vendors will continue to operate and that the economy both in the customer's home country and worldwide will have some economic and political stability. The issues of vendor viability including our limited resources and geopolitical instability will continue to make closing large license transactions difficult. Our ability to enter into new large license transactions also directly affects our ability to create additional consulting services and maintenance revenues, on which we also depend.

We expect to continue to incur losses and use cash and may not achieve or maintain profitability. In addition, we may continue to reduce our cash balance, which would cause our stock price to decline.

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We incurred losses of \$2.1 million and \$12.5 million for the three and nine months ended September 30, 2003, respectively. As of September 30, 2003, we had an accumulated deficit of \$185.0 million. We expect to continue to incur losses during the next fiscal year. Moreover, we expect to continue to incur significant sales and marketing and research and development expenses. As a result, we will need to generate significant revenues to achieve and maintain profitability. We cannot be certain that we can achieve this growth, maintain our past growth rates or generate sufficient revenues to achieve profitability. Cash and cash equivalents, short-term investments and restricted cash and long-term restricted cash at September 30, 2003 and December 31, 2002 was \$34.2 million and \$41.5 million, respectively.

Because a small number of customers account for a substantial portion of our revenues, our revenues are dependent upon our ability to continue to win large contracts with new and existing customers.

We derive a significant portion of our software license revenues in each quarter from a limited number of customers. The loss of a major customer in a particular quarter could cause a decrease in revenue, deferred revenues and net income. For the three months ended September 30, 2003, Royal Bank of Scotland and Canadian Imperial Bank of Commerce accounted for approximately 22% and 11% of our total revenues, respectively. For the three months ended September 30, 2002, USAA accounted for 43% of our total revenues, respectively. For the nine months ended September 30, 2003, Barclays and Royal Bank of Scotland accounted for 10% and 14% of our total revenues, respectively. For the nine months ended September 30, 2002, USAA, Hutchinson 3 G and Lloyds TBS accounted for 21%, 15% and 12% of our total revenues, respectively. While our size has increased and customer concentration has fluctuated, we expect that a limited number of customers will continue to account for a substantial portion of our revenues. As a result, if we lose a major customer, or if a contract is delayed or cancelled or we do not contract with new major customers, our revenues and net loss would be adversely affected. In addition, customers that have accounted for significant revenues in the past may not generate revenues in any future period, causing our failure to obtain new significant customers or additional orders from existing customers to materially affect our operating results.

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Our percentage of license revenues derived from deferred revenue may continue to decline, which may reduce our forecasting accuracy resulting in investor disappointment and resulting stock price reductions.

Historically, a large amount of license revenues flowed through deferred revenue. For the three months ended September 30, 2003 and 2002, 67% and 19%, respectively, of license revenues were derived from deferred revenue. For the nine months ended September 30, 2003 and 2002, 47% and 59%, respectively, of license revenues were derived from deferred revenue. Less reliance on deferred revenue requires the licensing of software that does not involve significant implementation or customization essential to its functionality. If we are unable to increase license revenues from products that do not involve significant implementation or customization essential to its functionality, we may miss our revenue forecasts, which may cause our stock price to decline.

Our reliance on international operations may cause reduced revenues and increased operating expenses.

For the three months ended September 30, 2003, international revenues were \$12.7 million or approximately 71% of our total revenues. For the three months ended September 30, 2002, international revenues were \$9.0 million or approximately 48% of our total revenues. For the nine months ended September 30, 2003, international revenues were \$38.5 million or approximately 79% of our total revenues. For the nine months ended September 30, 2002, international revenues were \$39.7 million or approximately 70% of our total revenues. We expect international revenues will continue to represent a significant portion of our total revenues in future periods. We have faced, and will continue to face, risks associated with:

- \* Difficulties in managing our widespread operations;
- \* Difficulties in hiring qualified local personnel;
- \* Seasonal fluctuations in customer orders;
- \* Longer accounts receivable collection cycles;
- \* Expenses associated with products used in foreign markets;
- \* Currency fluctuation and hedging activities; and
- \* Economic downturns in international economies.

Any of these factors could have a significant impact on our ability to license products on a competitive and timely basis and could adversely affect our operating expenses and net income. Our international sales are denominated in both the U.S. dollar and in local currencies. As a result, increases in the value of the U.S. dollar relative to foreign currencies could make our products less competitive in international markets and could negatively affect our operating results and cash flows.

Competition in our markets is intense and could reduce our sales and prevent us from achieving profitability and maintaining adequate liquidity.

Increased competition in our markets could result in price reductions, reduced gross margins and loss of market share, any one of which could reduce our future revenues and liquidity. The market for our products is intensely competitive, evolving and subject to rapid technological change. The intensity of competition is expected to increase in the future. As discussed above, we consider our primary competition to be from internal development, custom systems integration projects and application software competitors. In particular, we compete with:

- \* *Internal information technology departments:* in-house information technology departments of potential customers have developed or may develop systems that provide some or all of the functionality of our products. We expect that internally developed application integration and process automation efforts will continue to be a significant source of competition.
- \* *Point application vendors:* we compete with providers of stand-alone point solutions for web-based customer relationship management and traditional client/server-based, call-center service customer and sales-force automation solution providers.

Many of our competitors have greater resources and broader customer relationships than we do. In addition, many of these competitors have extensive knowledge of our industry. Current and potential competitors have established, or may establish, cooperative relationships among themselves or with third parties to offer a single solution and to increase the ability of their products to address customer needs.

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**We may experience a shortfall in revenue or earnings or otherwise fail to meet public market expectations, which could materially and adversely affect our business, the market price of our common stock and our liquidity.**

Our revenues and operating results may fluctuate significantly because of a number of factors, many of which are outside of our control. Some of these factors include:

- \* Size and timing of individual license transactions;
- \* Delay or deferral of customer implementations of our products;

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- \* Lengthening of our sales cycle;
- \* Further deterioration and changes in domestic and foreign markets and economies;
- \* Success in expanding our global services organization, direct sales force and indirect distribution channels;
- \* Timing of new product introductions and product enhancements;
- \* Appropriate mix of products licensed and services sold;
- \* Levels of international transactions;
- \* Activities of and acquisitions by competitors;
- \* Product and price competition; and
- \* Our ability to develop and market new products and control costs.

One or more of the foregoing factors may cause our operating expenses to be disproportionately high during any given period or may cause our revenues and operating results to fluctuate significantly. Based upon the preceding factors, we may experience a shortfall in revenues, earnings or liquidity or otherwise fail to meet public market expectations, which could materially and adversely affect our business, financial condition, results of operations and the market price of our common stock.

Our operating results fluctuate significantly and an unanticipated decline in revenues or cash flow may disappoint investors and result in a decline in our stock price.

Our quarterly revenues depend primarily upon product implementation by our customers. We have historically recognized most of our license and services revenue through the percentage-of-completion method, using labor hours incurred as the measure of progress towards completion of implementation of our products, and we expect this practice to continue. Thus, delays in implementation by our customers and systems integration partners would reduce our quarterly revenue. Historically, a significant portion of new customer orders have been booked in the third month of the calendar quarter, with many of these bookings occurring in the last two weeks of the third month. We expect this trend to continue and, therefore, any failure or delay in bookings would decrease our quarterly deferred revenue. If our revenues or operating margins are below the expectations of the investment community, our stock price is likely to decline.

Our inability to maintain and grow our relationships with systems integrators would harm our ability to market and implement our products and reduce future revenues.

Inability to establish or maintain relationships with systems integrators would significantly harm our capacity to license our software products. Systems integrators install and deploy our products, in addition to those of our competitors, and perform custom integration of systems and applications. Some systems integrators also engage in joint marketing and sales efforts with us. If these relationships deteriorate, we will have to devote substantially more resources to the sales and marketing, implementation and support of our products than we would have to otherwise. Our efforts may also not be as effective as those of the systems integrators, which could reduce revenues. In many cases, these parties have extensive relationships with our existing and potential customers and influence the decisions of these customers. A number of our competitors have stronger relationships with these systems integrators and, as a result, these systems integrators may be more likely to recommend competitors' products and services.

Failure to successfully customize or implement our products for a customer could prevent recognition of revenues, collection of amounts due or cause legal claims by the customer.

If a customer is not able to customize or deploy our products successfully, the customer may not complete expected product deployment, which would prevent recognition of revenues and collection of amounts due, and could result in claims against us. We have, in the past, had disputes with customers concerning product performance.

Our primary products have a long sales and implementation cycle, which makes it difficult to predict our quarterly results and may cause our operating results to vary significantly.

The period between initial contact with a prospective customer and the implementation of our products is unpredictable and often lengthy, ranging in date from three to twenty-four months. Thus, revenue, cash receipt and deferred revenue could vary significantly from quarter to quarter. Any delays in the implementation of our products could cause reductions in our revenues. The licensing of our products is often an enterprise-wide decision that generally requires us to provide a significant level of education to prospective customers about the use and benefits of our products. The implementation of our products involves significant commitment of technical and financial resources and is commonly associated with substantial implementation efforts that may be performed by us, by the customer or by third-party systems integrators. Customers generally consider a wide range of issues before committing to purchase our products, including product benefits, ability to operate with existing and future computer systems, vendor financial stability and longevity, ability to accommodate increased transaction volume and product reliability.

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Our stock price is subject to significant fluctuations.

Since our initial public offering in February 2000, the price of our common stock has fluctuated widely. We believe that factors such as the risks described herein or other factors could cause the price of our common stock to continue to fluctuate, perhaps substantially. In addition, recently, the stock market in general, and the market for high technology stocks in particular, has experienced extreme price fluctuations, which have often been unrelated to the operating performance of the affected companies. Such fluctuations could adversely affect the market price of our common stock.

We may incur in future periods significant stock-based compensation charges related to certain stock options and stock awards.

Based on certain accounting standards involving stock compensation, we will incur variable accounting costs related to the issuance of restricted stock and stock options, including those associated with our stock option cancellation/re-grant program. Accounting standards require us to remeasure compensation cost for such options each reporting period based on changes in the market value of the underlying common stock. Depending upon movements in the market value of our common stock, the variable accounting treatment of those stock options may result in significant additional non-cash compensation costs in future periods. Refer to the discussions under the caption "Non-Cash Compensation Expenses" set forth in Management's Discussion and Analysis of Financial Condition and Results of Operations in this report on Form 10-Q.

We are the target of a securities class action complaint and are at risk of securities class action litigation, which may result in substantial costs and divert management attention and resources.

Beginning in July 2001, Chordiant and certain of our officers and directors were named as defendants in several class action shareholder complaints filed in the United States District Court for the Southern District of New York, now consolidated as *In re Chordiant Software, Inc. Initial Public Offering Securities Litigation*, Case No. 01-CV-6222. In the amended complaint, the plaintiffs allege that Chordiant, certain of our officers and directors and the underwriters of our initial public offering ("IPO") violated the federal securities laws because the Company's IPO registration statement and prospectus contained untrue statements of material fact or omitted to state material facts regarding the compensation to be received by, and the stock allocation practices of, the IPO underwriters. The plaintiffs seek unspecified monetary damages and other

relief. Similar complaints were filed in the same court against hundreds of other public companies that conducted IPOs in the late 1990s. Although Chordiant has approved in principle a settlement proposed by the plaintiffs that would require no payment by Chordiant and result in the dismissal of all claims against Chordiant and its officers and directors with prejudice, the settlement remains subject to a number of procedural conditions, as well as formal approval by the Court. This action may divert the efforts and attention of our management and, if determined adversely to us, could have a material impact on our business.

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Our products need to successfully operate in a company-wide environment; if they do not, we may lose sales and suffer decreased revenues.

If existing customers have difficulty deploying our products or choose not to fully deploy the products, it could damage our reputation and reduce revenues. Our success requires that our products be highly scalable, and able to accommodate substantial increases in the number of users. Our products are expected to be deployed on a variety of computer hardware platforms and to be used in connection with a number of third-party software applications by personnel who may not have previously used application software systems or our products. These deployments present very significant technical challenges, which are difficult or impossible to predict. If these deployments do not succeed, we may lose future sales opportunities and suffer decreased revenues.

Defects in our products could diminish demand for our products and result in decreased revenues, decreased market acceptance and injury to our reputation.

Errors may be found from time to time in our new, acquired or enhanced products. Any significant software errors in our products may result in decreased revenues, decreased sales, injury to our reputation and/or increased warranty and repair costs. Although we conduct extensive product testing during product development, we have in the past discovered software errors in our products as well as in third party products, and as a result have experienced delays in the shipment of our new products. The latest major release of our primary product suite was introduced in January 2002.

To date, our sales have been concentrated in the financial services, travel and leisure and telecommunications markets, and if we are unable to continue sales in these markets or successfully penetrate new markets, our revenues may decline.

Sales of our products and services in three large markets-financial and insurance services, travel and leisure and telecommunications-accounted for approximately 79% and 85% of our total revenues for the three months ended September 30, 2003 and 2002, respectively. Sales of our products and services in three large markets-financial and insurance services, travel and leisure and telecommunications-accounted for approximately 81% of our total revenues for both the nine months ended September 30, 2003 and 2002, respectively. We expect that revenues from these three markets will continue to account for a substantial portion of our total revenues in 2003. If we are unable to successfully increase penetration of our existing markets or achieve sales in additional markets, or if the overall economic climate of our target markets deteriorates, our revenues may decline.

In addition, we cannot predict what effect the U.S. presence overseas or potential or actual political or military conflict have had or are continuing to have on our existing and prospective customers' decision-making process with respect to licensing or implementing enterprise-level products such as ours. If these or other outside factors cause existing or prospective customers to cancel or delay deployment of products such as ours, our operating results would be adversely affected.



Low gross margin in services revenues could adversely impact our overall gross margin and income.

Our services revenues have had lower gross margins than our license revenues. As a result, an increase in the percentage of total revenues represented by services revenues, or an unexpected decrease in license revenues, could have a detrimental impact on our overall gross margins. We anticipate that services revenues will continue to represent over 50% of total revenues. To increase services revenues, we must expand our services organization, successfully recruit and train a sufficient number of qualified services personnel and obtain renewals of current maintenance contracts by our customers. This expansion could further reduce gross margins in our services revenues.

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Because we have reduced the size of our workforce, we may not have the workforce necessary to support our platform of products, and if we need to rebuild our workforce in the future, we may not be able to recruit personnel in a timely manner, which could impact the development and sales of our products.

In 2002 and 2003, we reduced the size of our workforce and may carry out further reductions in the future. Our reductions were intended to align our operating expenses with our revenue expectations. However, these reductions or future reductions could have a negative impact on our operating performance because we may not have the workforce necessary to support the develop of additional products. Further, in the event that demand for our products increases as a result of a positive turn in the economy, we may need to rebuild our workforce or outsource certain functions to companies based in foreign jurisdictions and we may be unable to hire, train or retain qualified personnel in a timely manner, which may weaken our ability to market our products in a timely manner, negatively impacting our operations. Our success depends largely on ensuring that we have adequate personnel to support our platform as well as the continued contributions of our key management, engineering, sales and marketing and professional services personnel.

If we fail to introduce new versions and releases of functional and scalable products in a timely manner, customers may license competing products and our revenues may decline.

If we are unable to ship or implement enhancements to our products when planned, or fail to achieve timely market acceptance of these enhancements, we may suffer lost sales and could fail to achieve anticipated revenues. A majority of our total revenues have been, and are expected to be, derived from the license of our primary product suite. Our future operating results will depend on the demand for the product suite by future customers, including new and enhanced releases that are subsequently introduced. If our competitors release new products that are superior to our products in performance or price, or if we fail to enhance our products or introduce new features and functionality in a timely manner, demand for our products may decline. We have in the past experienced delays in the planned release dates of new versions of our software products and upgrades. New versions of our products may not be released on schedule or may contain defects when released.

We depend on technology licensed to us by third parties, and the loss or inability to maintain these licenses could prevent or delay sales of our products.

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We license from several software providers technologies that are incorporated into our 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, if at all. The loss of technology licenses could result in delays in the license of our products until equivalent technology, if available, is developed or identified, licensed and integrated into our products. Even if substitute technologies are available, there can be no guarantee that we will be able to license these technologies on commercially reasonable terms, if at all.

Defects in third party products associated with our products could impair our products' functionality and injure our reputation.

The effective implementation of our products depends upon the successful operation of third-party products in conjunction with our products. Any undetected errors in these third-party products could prevent the implementation or impair the functionality of our products, delay new product introductions or injure our reputation. In the past, while our business has not been materially harmed, product releases have been delayed as a result of errors in third-party software and we have incurred significant expenses fixing and investigating the cause of these errors.

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Our customers and system integration partners may have the ability to alter our source code and resulting inappropriate alterations could adversely affect the performance of our products, cause injury to our reputation and increase operating expenses.

Customers and system integration partners may have access to the computer source code for certain elements of our products and may alter the source code. Alteration of our source code may lead to implementation, operation, technical support and upgrade problems for our customers. This could adversely affect the market acceptance of our products, and any necessary investigative work and repairs could cause us to incur significant expenses and delays in implementation.

If our products do not operate with the hardware and software platforms used by our customers, our customers may license competing products and our revenues will decline.

If our products fail to satisfy advancing technological requirements of our customers and potential customers, the market acceptance of these products could be reduced. We currently serve a customer base with a wide variety of constantly changing hardware, software applications and networking platforms. Customer acceptance of our products depends on many factors such as:

- \* Our ability to integrate our products with multiple platforms and existing or legacy systems;
- \* Our ability to anticipate and support new standards, especially Internet and enterprise Java standards; and
- \* The integration of additional software modules and third party software applications with our existing products.

Our failure to successfully integrate with future acquired or merged companies and technologies could prevent us from operating efficiently.

Our business strategy includes pursuing opportunities to grow our business, both through internal growth and through merger, acquisition and technology and other asset transactions. To implement this strategy, we may be involved in merger and acquisition activity, additional technology and asset purchase transactions. Merger and acquisition transactions are motivated by many factors, including, among others, our

desire to grow our business, acquire skilled personnel, obtain new technologies and expand and enhance our product offerings. Growth through mergers and acquisitions has several identifiable risks, including difficulties associated with successfully integrating distinct businesses into new organizations, the substantial management time devoted to integrating personnel, technology and entire companies, the possibility that we might not be successful in retaining the employees, undisclosed liabilities, the failure to realize anticipated benefits (such as cost savings and synergies) and issues related to integrating acquired technology, merged/acquired companies or content into our products (such as unanticipated expenses). Realization of any of these risks in connection with any technology transaction or asset purchase we have entered into, or may enter into, could have a material adverse effect on our business, operating results and financial condition.

If we become subject to intellectual property infringement claims, these claims could be costly and time-consuming to defend, divert management's attention, cause product delays and have an adverse effect on our revenues and net income.

We expect that software product developers and providers of software in markets similar to our target markets will increasingly be subject to infringement claims as the number of products and competitors in our industry grows and the functionality of products overlap. Any claims, with or without merit, could be costly and time-consuming to defend, divert our management's attention or cause product delays. We have no patents that we could use defensively against any company bringing such a claim. If any of our products were found to infringe a third party's proprietary rights, we could be required to enter into royalty or licensing agreements to be able to sell our products. Royalty and licensing agreements, if required, may not be available on terms acceptable to us or at all.

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**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We are exposed to the impact of interest rate changes, foreign currency fluctuations and change in the market values of our investments. The following table presents the amounts of short-term investments and restricted cash that are subject to interest rate risk by year of expected maturity and average interest rates as of September 30, 2003 (in thousands):

|  | 2003 |
|--|------|
| <b>Fair Value</b>                          |      |
|  | 2004 |
| <b>Fair Value</b>                          |      |
| Short-term investments and restricted cash | \$   |
|  | --   |
|  | \$   |
|  | --   |
|  | \$   |

581

\$

581

Average interest rates

--

%

1.60

%

#### Interest Rate Risk.

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio. We have not used derivative financial instruments to hedge our investment portfolio. We invest excess cash in debt instruments of the U.S. Government and its agencies, and in high-quality corporate issuers and, by policy, limit the amount of credit exposure to any one issuer. We protect and preserve invested funds by limiting default, market and reinvestment risk. Investments in both fixed rate and floating rate interest earning instruments carries a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities, which have declined in market value due to changes in interest rates.

#### Foreign Currency Risk.

International revenues from our foreign subsidiaries accounted for approximately 71% and 48% of total revenues for the three months ended September 30, 2003 and 2002, respectively. International revenues from our foreign subsidiaries accounted for approximately 79% and 70% of total revenues for the nine months ended September 30, 2003 and 2002, respectively. International sales are made mostly from our foreign sales subsidiaries in their respective countries and are typically denominated in the local currency of each country. These subsidiaries also incur most of their expenses in the local currency. Accordingly, all foreign subsidiaries use the local currency as their functional currency.

Additionally, one of our foreign subsidiaries holds cash equivalent investments in currencies other than its respective local currency. Such holdings increase our exposure to foreign exchange rate fluctuations. As exchange rates vary, the holdings may magnify foreign currency exchange rate fluctuations or upon translation or adversely impact overall expected profitability through foreign currency losses incurred upon the sale or maturity of the investments. Foreign currency losses, net for the three months ended September 30, 2003 and 2002 were \$0.1 million and zero, respectively. Foreign currency net gains and losses for both the nine months ended September 30, 2003 and 2002, respectively, were less than \$0.1 million.

Our international business is subject to risks, including, but not limited to changing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions, and foreign exchange rate volatility when compared to the United States. Accordingly, our future results could be materially adversely impacted by changes in these or other factors.

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## Item 4. Controls and Procedures

*Limitation on Effectiveness of Controls.* Rules promulgated under the Securities Exchange Act of 1934, as amended (the "Act") define "disclosure controls and procedures" to mean controls and procedures that are designed to ensure that information required to be disclosed by public companies in the reports filed or submitted under the Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms ("Disclosure Controls"). New rules promulgated under the Act define "internal control over financial reporting" to mean a process designed by, or under the supervision of, a public company's principal executive and principal financial officers, or persons performing similar functions, and effected by such 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 ("GAAP"), including those policies and procedures that (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company, (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company and (iii) 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 ("Internal Controls").

We have designed our Disclosure Controls and Internal Controls to provide reasonable assurances that their objectives will be met. A control system, no matter how well designed and operated, can provide only reasonable, but not absolute, assurance that its objectives will be met. All control systems are subject to inherent limitations, such as resource constraints, the possibility of human error and the possibility of intentional circumvention of these controls. Furthermore, the design of any control system is based in part upon assumptions about the likelihood of future events, which assumptions may ultimately prove to be incorrect. As a result, we cannot assure you that our control system will detect every error or instance of fraudulent conduct.

*Evaluation of Disclosure Controls.* Our Chief Executive Officer and our Chief Financial Officer are responsible for establishing and maintaining our Disclosure Controls. Our Chief Executive Officer and our Chief Financial Officer, after evaluating the effectiveness of our Disclosure Controls as of September 30, 2003, have concluded that our Disclosure Controls are effective to provide reasonable assurances that our Disclosure Controls will meet their defined objectives.

*Changes in internal controls.* During the period covered by this Quarterly Report on Form 10-Q, we did not make any significant changes in our Internal Controls or in other factors that could significantly affect these controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

**PART II - OTHER INFORMATION.**

## Item 1. Legal Proceedings

Beginning in July 2001, we and certain of our officers and directors, as well as the underwriters of our initial public offering ("IPO") and hundreds of other companies ("Issuers"), individuals and IPO underwriters, were named as defendants in a series of class action shareholder complaints filed in the United States District Court for the Southern District of New York. Those cases are now consolidated under the caption, *In re Initial Public Offering Securities Litigation*, Case No. 91 MC 92. In the amended complaint against Chordiant, the plaintiffs allege that Chordiant, certain of our officers and directors and our IPO underwriters violated section 11 of the Securities Act of 1933 based on allegations that Chordiant's registration statement and prospectus failed to disclose material facts regarding the compensation to be received by, and the stock allocation practices of, the IPO underwriters. The complaint also contains a claim for violation of section 10(b) of the Securities Exchange Act of 1934 based on allegations that this omission constituted a deceit on investors. The plaintiffs seek unspecified monetary damages and other relief. In October 2002, the parties agreed to toll the statute of limitations with respect to Chordiant's officers and directors until September 30, 2003, and on the basis of this agreement, our officers and directors were dismissed from the lawsuit without prejudice. In February 2003, the court issued a decision denying the motion to dismiss the Section 11 claims against Chordiant and almost all of the other company defendants and denying the motion to dismiss the Section 10(b) claims against Chordiant and many of the company defendants. In June 2003, Issuers and Plaintiffs reached a tentative settlement agreement that would, among other things, result in the dismissal with prejudice of all claims against the Issuers and their officers and directors in the IPO Lawsuits. In addition, the tentative settlement guarantees that, in the event that the Plaintiffs recover less than \$1 billion in settlement or judgment against the Underwriter defendants in the IPO Lawsuits, the Plaintiffs will be entitled to recover the difference between the actual recovery and \$1 billion from the insurers for the Issuers. Although Chordiant has approved this settlement proposal in principle, it remains subject to a number of procedural conditions, as well as formal approval by the Court. In September 2003, in connection with the possible settlement, those officers and directors who had entered tolling agreements with Plaintiffs (described above) agreed to extend those agreements so that they would not expire prior to any settlement being finalized.

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**Item 2. Changes in Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

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

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits and Reports on Form 8-K**

(a) Exhibits

The exhibits listed on the accompanying index to exhibits are filed or incorporated by reference (as stated therein) as part of this Quarterly Report on Form 10-Q.

(b) Reports on Form 8-K

On July 22, 2003, the Company furnished a Current Report on Form 8-K which announced the Company's financial results for the quarter ended June 30, 2003 and certain other information. A copy of the Company's press release announcing the financial results and certain other information was attached and incorporated therein by reference.

On September 10, 2003, the Company filed a Current Report on Form 8-K announcing the appointment of R. Andrew Eckert as a Class II Director and the resignation of Bill Ford as a Class II Director. A copy of the Company's press release announcing Mr. Eckert's appointment to the Board and Mr. Ford's resignation from the Board was attached and incorporated therein by reference.

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**Chordiant Software, Inc.**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

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Dated: November 3, 2003

Chordiant Software, Inc.  
(Registrant)  
/s/ Steve G. Vogel

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Steve G. Vogel  
Senior Vice President of Finance, Chief Financial Officer and Secretary  
(Principal Financial and Accounting Officer)

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### **EXHIBIT INDEX**

- 3.1 Amended and Restated Certificate of Incorporation of Chordiant Software, Inc. (filed as Exhibit 3.1 with Chordiant's Registration Statement on Form S-1 (No. 333-92187) filed on December 6, 1999 and incorporated herein by reference).
- 3.2 Amended and Restated Bylaws of Chordiant Software, Inc. (filed as Exhibit 3.2 with Chordiant's Registration Statement on Form S-1 (No. 333-92187) filed on December 6, 1999 and incorporated herein by reference).
- 3.3 Amended and Restated Bylaws of Chordiant Software, Inc. (filed as Exhibit 3.2 with Chordiant's Registration Statement on Form S-1 (No. 333-92187) filed on December 6, 1999 and incorporated herein by reference).
- 4.1 Specimen Common Stock Certificate (filed as Exhibit 4.2 with Amendment No. 2 to Chordiant's Registration Statement on Form S-1 (No. 333-92187) filed on February 7, 2000 and incorporated herein by reference).
- 4.2 Amended and Restated Registration Rights Agreement, dated as of September 28, 1999 (filed as Exhibit 4.3 with Chordiant's Registration Statement on Form S-1 (No. 333-92187) filed on December 6, 1999 and incorporated herein by reference).
- 4.3 Subordinated Registration Rights Agreement, dated July 19, 2000, by and among Chordiant Software, Inc. and the Sellers of capital stock of White Spider Software, Inc. (filed as Exhibit 4.3 with Chordiant's Registration Statement on Form S-4 (No. 333-54856) filed on February 2, 2001 and incorporated herein by reference).
- 4.4 Registration Rights Agreement, dated May 17, 2001, by and between Chordiant Software, Inc. and ActionPoint, Inc. (filed as Exhibit 4.4 to Chordiant's Annual Report on Form 10-K filed on March 29, 2002 and incorporated herein by reference).
- 4.5 Warrant agreement, dated August 12, 2002, by and between Chordiant Software, Inc. and International Business Machines Corporation ("IBM") (filed as Exhibit 4.5 to Chordiant's Quarterly Report on Form 10-Q filed on May 15, 2003 and incorporated herein by reference).
- 10.29\* Change of Control Agreement, dated April 24, 2003, by and between Chordiant Software, Inc. and Allen Swann.
- 10.30 Second Amendment to Amended and Restated Loan and Security Agreement by and between Chordiant Software, Inc. and Comerica Bank-California, successor in interest to Imperial Bank, dated March 28, 2003.
- 24.1 Power of Attorney (set forth on signature page).
- 31.1 Certification required by Rule 13a-14(a) or Rule 15d-14(a).
- 31.2 Certification required by Rule 13a-14(a) or Rule 15d-14(a).
- 32.1++ Certification required by Rule 13a-14(a) or Rule 15d-14(a) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).

\* Management contract or compensatory plan or arrangement.

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This certification "accompanies" the Quarterly Report on Form 10-Q to which it relates, is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of the Company under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Annual Report on Form 10-K), irrespective of any general incorporation language contained in such filing.