ART TECHNOLOGY GROUP INC
Form 10-K
March 28, 2003

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

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

For the Fiscal Year Ended December 31, 2002

or

o **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 000-26679

Art Technology Group, Inc.

(Exact name of registrant as specified in its charter)

Delaware *(State or other jurisdiction of incorporation or organization)*	**04-3141918** *(I.R.S. Employer Identification Number)*
25 First Street **Cambridge, Massachusetts** *(Address of principal executive offices)*	**02141** *(Zip Code)*

(617) 386-1000

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, $0.01 par value with
Associated Preferred Stock Purchase Rights
(Title of Class)

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 þ No o

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

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

The aggregate market value of the voting stock held by non-affiliates of the registrant was approximately $70,516,000 based on the closing price of the registrant s common stock on the Nasdaq National Market on June 28, 2002.

The number of shares of the registrant s common stock outstanding as of March 21, 2003, was 70,987,449.

Documents Incorporated by Reference

Portions of the registrant s proxy statement for its annual meeting of stockholders to be held on May 21, 2003 are incorporated by reference in Items 10, 11, 12 and 13 of Part III.

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ART TECHNOLOGY GROUP, INC.

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ATG, Art Technology Group and Dynamo are our registered trademarks, and ATG Scenario Personalization and ATG Data Anywhere Architecture are our service marks. This report also includes trademarks, service marks and trade names of other companies.

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PART I

Item 1. *Business*

Overview

We develop and market software that enables consumer, retail and financial services companies to dynamically market, sell and provide services to their customers online. We offer proven, flexible online marketing, sales, and self-service software applications for consumer facing e-commerce sites. We also offer our clients related professional services including support, education and implementation services.

Our applications are designed to help businesses gain information about their online customers and provide them the tools that enable them to build long-term relationships with their customers. In particular we believe that businesses want to optimize their consumer relations throughout the whole lifecycle of marketing to sales to post-sale services, whether online or offline. We seek to differentiate ourselves by designing products that make it simpler to develop and maintain user profile information across multiple complex data sources, easier to model and influence desired user behavior, and faster to develop and maintain dynamic web content with a smaller investment than otherwise possible.

As of December 31, 2002, we had an installed base of more than 550 customers, with 52% in the United States, 42% in Europe and the remainder in other countries. Our principal target markets are Global 2000 companies, government organizations and other businesses that have large numbers of online users and utilize the Internet as a primary business channel. We have historically focused on providing our software and services to businesses in financial services, retail, media and entertainment, telecommunications, consumer products and services industries. We have delivered online solutions to companies such as Aetna Services, Alcatel, American Airlines, Barclays Global Investors, Best Buy, BMG Direct, Eastman Kodak, Ford Motor Credit, HSBC, J. Crew, Sun Microsystems, Walgreens, and Wells Fargo.

We offer businesses software products and related services in three functional areas:

Our marketing applications are designed to allow businesses to attract new customers, promote new offerings to existing customers, and improve the cost-effectiveness of existing marketing expenditures. Our clients use our tools to integrate their online marketing activities with related sales and self-service initiatives. Our tools are designed to allow businesses to increase marketing effectiveness by visually defining desired customer experience activities and events that will drive desirable customer behavior.

Our online sales applications are used by our clients to facilitate transactions with consumers and our client s channel partners. These commerce offerings are designed for the development of large consumer-facing e-commerce sites and channel partner extranets. We believe that using our online sales and marketing solutions together, our customers can create sophisticated promotions and offers that can drive incremental sales.

Our self-service solutions are designed to decrease call-center service costs, to improve the speed with which customer needs are met, and to increase customer loyalty and satisfaction. We believe our self-service solutions become more useful through the use of our advanced personalization capabilities, that are designed to increase the likelihood that customer inquiries will be managed online avoiding the need for costly call center inquiry.

Our Strategy

Our objective is to be the industry leader in providing consumer-based companies with software that integrates the whole customer lifecycle, from marketing and selling to service, including the automation of online and offline transactions. We intend to achieve this objective by implementing the following key components of our strategy:

Focus on Commerce and Self-Service Applications. We believe the functionality and performance of our personalization and scenario servers historically have provided us with a significant differentiator for our products, and we plan to focus our enhancement efforts on these applications. In order to

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enhance these applications we will seek to add additional functionality that we believe will drive higher customer satisfaction and greater reliability, usability and scalability. We also will seek to offer our commerce and self-service capabilities as Web services where practical, in order to help our customers extend their enterprises and generate new revenue sources and cost savings.

Increase Penetration of Key Vertical Markets. We plan to focus our development and marketing efforts on consumer branded companies by developing complete solutions marketing capability that is specific to individual industries. These industries are characterized by complex transaction-oriented product offerings with sophisticated marketing needs. We believe that by optimizing our products to meet the needs of companies in these industries we can increase the benefits that we offer to these companies and in turn increase our revenues and market shares in the targeted industries.

Support Open Application Server Infrastructure. We support the adoption of open application server infrastructure by our old and new customers. Our current product suite fully supports application server platforms from BEA Services and IBM, our two principal competitors in the platform market. We plan to work closely with BEA Services and IBM to increase the value both new and existing customers receive from our products regardless of the platform they select. We plan to further invest in careful integration of our most valuable product components with the development tools, application integration and portal infrastructure capabilities of these platforms.

Continue Focused Marketing Initiatives. We are continuing to invest in promoting our company, technology, applications and solution sets through focused initiatives such as direct marketing, public relations, seminars, trade shows, speaking opportunities, web marketing, business alliance co-marketing, case studies, *ATG Innovator* magazine and the ATG Open User Conference. As we add industry solutions, we will develop complete solutions marketing capability that is specific to each industry we choose.

Leverage Existing Sales Channels. We sell our products directly to end-users and through value-added resellers. In addition, approximately one-half of our product revenue is co-sold with a variety of business entities, including systems integrators, solution providers, technology partners and value-added resellers. We currently have a broad range of business alliances throughout the world, including large system integrators like Accenture, Cap Gemini Ernst & Young, EDS, Fujitsu Consulting, HP Consulting, and SAIC, as well as regional integrators such as Analysts International, E-Tree, Rikei, Thales-IS and SBI. Our goal is to maintain close relationships directly with our customers and to motivate systems integrators to implement our applications in their projects and solution sets.

Leverage and Expand Service Capabilities. We have extensive experience in Web application development and integration services. Through our Professional and Educational Services organizations, we provide services to train our systems integrators, value added resellers and complementary software vendors in the use of our products and offer consulting services to assist with customer implementations. We seek to motivate our business allies and sales forces to provide joint implementation services to our end user customers. We intend to continue to seek additional opportunities to increase revenues from product sales by expanding our base of partners trained in the implementation and application of our products.

Products

The market for our products is changing rapidly. When we first began to develop software products, many of the innovative and high performance elements of the application and development platform that we now use were not readily available in the market. We therefore had to create a high performance application server and many of the middle tier elements of our platform to provide for a building block style of rapid development, where one component makes use of the capabilities of another in an additive sense.

Our product strategy has also long supported customer adoption of the whole ATG product platform as a highly reusable system of Web development components. Our customers apply high performance ATG technologies in the areas of transaction management, personalization, process modeling, and web development to go faster and further with their development activities at a much lower cost than is possible using comparable custom Web development methods. Inevitably, some of the innovative methods and technologies that once differentiated us are coalescing into industry standards and are being subsumed by capabilities offered by the major operating system and infrastructure vendors.

Our products include the following:

ATG Relationship Management Platform. The ATG Relationship Management Platform provides a rich set of features to enable online marketing, sales, and service solutions. The functionality of the ATG Relationship Management Platform provides businesses with insight into customer behavior and the capability to respond quickly to changing customer and market needs. The ATG Relationship Management Platform is distinguished from similar products by its robust data access capabilities -the Data Anywhere Architecture - and its means of modeling and responding to consumer behavior. We plan to build upon our marketing platform capabilities through a combination of internal development and external partnering and product sourcing.

ATG Commerce. ATG Commerce offers a commerce solution for selling to business customers, channel partners, and consumers. Using ATG Commerce, companies can manage multiple phases of the end user lifecycle marketing, sales, and service while also leveraging our personalization functionality to more effectively manage relationships. ATG Commerce is built on an adaptable, flexible framework and our data access capability, and is sold bundled with the ATG Relationship Management Platform.

Online Self-Service with ATG Portal. The ATG Portal offers rich relationship management and personalization features on a proven platform that includes tools for developing, deploying, and managing customer, partner, and employee portals. It features a set of application building blocks called portlets, pre-built sample applications, and a suite of administrative tools. ATG Portal is sold bundled with the ATG Relationship Management Platform.

Customers from many industry segments can develop self-service applications using various combinations of the ATG Relationship Management Platform, ATG Portal, and ATG Commerce products. We plan to work with our customers and partners to further create industry solution frameworks from these successful customer-developed applications.

Application Services:

ATG Publishing. The ATG Publishing module provides a customizable workflow engine so that non-technical people can create, manage, preview, and deploy content while ensuring proper quality control. The publishing tools provide the means to create product catalogs, post updates to knowledge base articles, and design targeted e-mail marketing campaigns.

ATG Search. Through our agreement with Autonomy, we offer powerful search capabilities that help customers, partners, and employees find the information they need, thereby lowering order abandonment, reducing call center costs, enhancing customer satisfaction, and increasing employee productivity.

Our products are fully compatible with the BEA WebLogic Application Server, and the IBM WebSphere Application Server, and also run on our ATG Dynamo Application Server.

Services

Our services organization provides a variety of consulting, design, application development, integration, training and support services in conjunction with our products. These services are provided through our Professional Services, Education, and Customer Support Service offerings.

Professional Services. The primary goal of our Professional Services organization is to increase customer satisfaction with our application solutions. Our Professional Services include five primary service offerings:

Structured Enabling Services. Working with a client or designated team, we offer Structured Enabling Services to facilitate project success. This is our preferred delivery model.

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Packaged Offerings. We leverage the e-business expertise we have gained through hundreds of projects in order to offer a variety of packaged services to our customers. Packages range from services designed to help customers gain momentum with their portal or commerce project, to assessing the benefits of upgrading to the latest version of our applications and to technical implementation programs.

Custom Solutions. We offer customized professional services solutions tailored to meet the specific needs of our customers across an entire project. Consulting services can include a combination of system architecture design, project management, web design, technical training and business consulting services.

Express Services. Our Express Services offerings are short-term engagements designed to help our customers with a specific component of their project. Consulting services may consist of system architecture design, project management, web design, or technical training and support.

Comprehensive Business Innovations. Our Comprehensive Business Innovations are full life cycle solution project services with an emphasis on deploying innovative, mission critical technologies related to our products.

Education. We provide a broad selection of educational programs designed to train customers and partners on our applications. This curriculum addresses the educational needs of developers, technical managers, business managers, page designers, and system administrative personnel/ deployment engineers. ATG Education also offers an online learning program that complements our instructor-led training. Developers can become certified by completing the ATG Certified Dynamo Developer examination. We also offer end user training to complete the roll out of a customer s application. We provide a full range of instructor-led and self-paced training solutions to assist customers with this key initiative.

Customer Support Services. We offer five levels of customer support ranging from our evaluation support program, which is available for 30 days, to our Premier Support Program, which includes access to technical support engineers 24 hours a day, seven days per week, for customers deploying mission critical applications. Customers are entitled to receive software updates, maintenance releases, online documentation and bug reports, and technical support for an annual maintenance fee.

Customers

As of December 31, 2002, we had an installed base of more than 550 customers. Our principal target markets are Global 2000 companies, government organizations and other businesses that have large number of online users and utilize the Internet as a primary business channel. Our customers represent a broad spectrum of enterprises within diverse industry sectors. The following is a partial list:

Consumer Retail	Manufacturing
Best Buy Companies, Inc.	Alcatel
Cabela s	Abbott Laboratories
Eastman Kodak	Eastman Kodak
J. Crew	General Motors
Martha Stewart Living Omnimedia	Newell Rubbermaid
Neiman Marcus	Procter & Gamble
Restoration Hardware	
Target Corporation	
The Finish Line	
Walgreens	

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Financial Services	Communication & Technology
A.G. Edwards	Adobe
John Hancock Funds	Alcatel
KeyBank	BellSouth
Citibank	EMC
Ford Motor Credit	Handspring
Charles Schwab & Co., Inc.	Hewlett Packard
HSBC	Intuit
Barclays Global Investors	Sun Microsystems
MFS Investment Management	
Dreyfus Service Corporation	
Merrill Lynch	
Pioneer Investments	
Zurich Scudder Investments	

International	Travel, Media and Entertainment
Benetton	American Airlines
Kingfisher PLC	BMG Direct
Direkt Anlage Bank	Gameplay GB Ltd.
Pirelli	Hilton Hotels Corporation
BBC Technology Service	Hyatt
Philips	Meredith Corporation
Heidelberger Druckmaschinen	Nintendo
Lavazza	Reader s Digest
Roche France	Sega.com
Premier Farnell	Six Continents Hotels
Consignia	Sony Online Entertainment Inc.
Sasol	The MTVi Group
Vodafone	

Technology

We believe we are a technology leader in providing online marketing, sales and service applications due to our use of the Java programming language, our own strong component model, and our enterprise integration tools and methods.

Java Foundation. Our products are written in Java and support Java programming for customization and extension, except for a few integration and installation modules that must be implemented in other programming languages. We have performed internal tests to certify that our ATG 6.0 Relationship Management Platform supports the current J2EE standards established by Sun Microsystems.

We believe that our Java implementation results in the following benefits:

STRONG COMPONENT MODEL. Java provides a component standard known as JavaBeans, which enables developers to segment their code into discrete, well-defined units which can be assembled in a building block fashion to create new applications. JavaBeans modularity makes it easier to create reusable software as well as maintain existing systems.

PLATFORM NEUTRALITY. Java s portability allows our applications to be run on virtually any major computer system without modification. This portability eliminates porting costs normally required to support multiple platforms or to change platforms, while allowing us to release products on major platforms simultaneously.

ENTERPRISE INTEGRATION. We believe that Java s portability and direct support for distributed applications are helping Java to become the de facto standard language for enterprise system integration. We expect that Sun Microsystems establishment of J2EE standards will make integration even easier for those enterprise systems that support J2EE specifications.

FEWER PROGRAMMING ERRORS. Java s automatic memory management reduces memory corruption errors, which typically represent the most costly and difficult software bugs in conventional compiled languages such as C or C++.

ACCELERATED DEVELOPMENT. We believe that the above features, combined with the broad availability of high-quality Java development tools, result in faster development time.

Modular, Standards-Based Component Architecture. One of the key features of our product architecture is its high degree of modularity, achieved by building additional functionality on top of the JavaBeans component technology. Customizations and extensions built by our customers or partners using industry standard JavaBean components can be managed by our ATG Nucleus system. The ATG Nucleus system enhances the naming, configuration and lifecycle of each component, allowing components to be added, extended, duplicated or replaced without recompilation of the rest of the system. The modularity of our component technology allows our products to be adapted to meet future business needs. In contrast, producers of non-modular products must try to anticipate and develop additional functionality at the time that they market their products.

One of the most powerful uses of our component technology is to integrate our software with external enterprise systems. We provide reference implementations of integration components while enabling our customers and partners to easily replace our reference components with new components that provide the same function but integrate with their existing systems. We adhere to industry standards to enable our products to leverage technologies produced by third parties and to protect the development investments of our partners and customers.

Research and Development

Our research and development group is responsible for core technology, product architecture, product development, quality assurance, documentation and third-party software integration. This group also assists with pre-sale, customer support activities and quality assurance tasks supporting the Professional Services group.

Since we began focusing on selling software products in 1996, the majority of our research and development activities have been directed towards creating new versions of our products, which extend and enhance competitive product features. We continue to focus our efforts on developing new and innovative products, as well as integrating our products with external enterprise systems and third party application servers. Our research and development expenses were $21.7 million in 2002, $30.1 million in 2001, and $19.0 million in 2000. The systems we integrate with include relational databases, content management systems, search engines, and credit card payment servers.

Sales Coverage Model

Our principal target markets are leading organizations with large constituencies who use the Internet as a primary business channel. We target these potential customers through our direct sales force and through channel partners, including systems integrators and other technology partners. We currently have approximately 160 business alliances throughout the world.

We employ one group of sales professionals who are compensated based on product and services sales made directly to end-users and through business partners, and another group of sales professionals who are dedicated to recruiting, training, developing business plans and joint selling and marketing with business

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alliances such as system integrators and value added resellers. We train and assist our business partners in promoting, selling, deploying, extending and supporting our products. The objective of this strategy is to establish close product relationships directly with our customers and to motivate systems integrators to adopt the ATG suite of products for commerce and self-service projects for their clients.

Our co-marketing relationships are with major hardware vendors, software providers, systems integrators and other consulting firms that serve the market for information system products and services. The objective of this co-marketing strategy is to assist our partners in creating demand for our products and extend our presence globally and regionally.

Set forth below is a partial list of organizations with which we have selling and marketing relationships:

North America

Accenture

Analysts International
Autonomy
Bell Canada
Blast Radius
Cap Gemini Ernst & Young
ClearCommerce
CEI America
Covansys
Critical Mass
Documentum
EDS
Fujitsu Consulting

GTSI (Fed Government)

Hewlett Packard
IBM
Immix Technology (Fed Government)
McFayden Consulting
Meritage
Montage-DMC
NCR
RTGX (Fed Government)
SAIC (Fed Government)
SBI & Company
Sun Microsystems
TIBCO Systems
Unisys (Fed Government)

International

Accenture

Cap Gemini Ernst & Young
Dimension Data
EDB
EDS
E-Tree

ETC

Fujitsu Consulting
HP Japan

Thales IS
Rikei

As of December 31, 2002, in addition to offices throughout the United States, we had sales personnel located in Australia, Canada, England, France, Germany, Japan, the Netherlands and Sweden. Our revenues from sources outside the United States were $30.1 million, or 30% of total revenue, in 2002, $47.6 million, or 34% of total revenue, in 2001, and $37.6 million, or 23% of total revenue, in 2000. During the past year, we have established relationships with new international partners and have added key international accounts.

Competition

The market for online sales, marketing and self-service software is intensely competitive, subject to rapid technological change, and significantly affected by new product introductions and other market activities. We expect competition to persist and intensify in the future. We currently have five primary sources of competition:

platform vendors such as BEA Systems and IBM, who are also our partners;

Microsoft, with whom we compete in commerce applications and, less directly, in the platform arena;

commerce-oriented vendors, such as Blue Martini and BroadVision, which compete on various levels including portals and e-commerce;

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commerce, marketing and self-service vendors such as Chordiant, E.piphany and Kana, which may or may not have a vertical industry focus; and

in-house development efforts by potential customers or partners.

We compete against these alternative solutions by focusing on online sales, marketing and self-service applications for consumer-facing businesses. We believe our solutions provide these companies with a rapid time to return on investment, attractive long-term total cost of ownership, a way to present a single view of themselves to their customers, the ability to improve the productivity and effectiveness of customer interactions, and the flexibility to adapt to rapidly changing and often unpredictable market needs.

We seek to provide our customers with a rapid time to return on investment through strong out-of-the-box functionality for online sales, marketing and self-service built on a flexible, component architecture that is practical and cost-effective to customize. These capabilities can enable customers to get to market quickly in a manner that exploits their competitive advantages which helps drive their return on investment.

Our products allow companies to present a single view of themselves to their customers through our Data Anywhere Architecture. The Data Anywhere Architecture allows companies to easily access and utilize data in the enterprise regardless of the data storage format or location. The data can be leveraged in their native form without having to move, duplicate or convert them. By enabling these capabilities in a cost-effective manner, we believe our products can help companies protect their brand and keep their customers from becoming confused or frustrated all of which positively impact customer satisfaction and loyalty.

Our Scenario-Personalization is designed to help companies make each interaction with their customers more productive and effective. These personalization capabilities help ensure that consumers are presented with the most relevant information. By avoiding information overload, consumers are more likely to have their needs met through the low cost online channel increasing the speed at which customer needs are met and decreasing the likelihood the consumer will use a more expensive channel such as a call center. Scenario-Personalization can also make interactions with consumers more effective for our customers. Scenario-Personalization allows a business user to visually design a sequence of behaviors that our customer would like to encourage a consumer to undertake which can lead to a specific goal such as a site registration or transaction. Our Scenario-Personalization capabilities automatically monitor and encourage consumers to follow these pre-defined behavior patterns enabling our customer to maximize the effectiveness of each interaction with the consumer.

Finally, we believe the combination of our out-of-the-box functionality, our component architecture and the Data Anywhere Architecture helps companies that use our products to adapt quickly and economically to rapidly changing and unanticipated market needs.

As described above under Our Strategy, we support the adoption of open application server infrastructure by our old and new customers and plan to work closely with other platform vendors to increase the value customers receive from our products regardless of the platform they select. We intend to focus our future development and marketing efforts on applications rather than our platform, and as a result we expect our business and operating results will be less affected by our competition with platform vendors such as BEA Systems and IBM. We cannot assure you, however, that open application server infrastructure will not result in increased competition, or other changes in the competitive landscape, in the market for applications.

Proprietary Rights and Licensing

Our success and ability to compete depends on our ability to develop and protect the proprietary aspects of our technology and to operate without infringing on the proprietary rights of others. We rely on a combination of trademark, trade secret and copyright law and contractual restrictions to protect our proprietary technology. These legal protections afford only limited protection for our technology. We seek to protect our source code for our software, documentation and other written materials under trade secret and copyright laws. We license our software pursuant to signed license, click through or shrink wrap agreements, which impose restrictions on the licensee s ability to use the software, such as prohibiting reverse engineering and limiting the use of copies. We also seek to avoid disclosure of our intellectual property by

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requiring employees and consultants with access to our proprietary information to execute confidentiality agreements and by restricting access to our source code. Due to rapid technological change, we believe that factors such as the technological and creative skills of our personnel, new product developments and enhancements to existing products are more important than legal protections to establish and maintain a technology leadership position.

Employees

As of December 31, 2002, we had a total of 555 employees. Of our employees, 137 were in research and development, 176 in sales and marketing, 171 in professional services and 71 in finance and administration. Our future success will depend in part on our ability to attract, retain and motivate highly qualified technical and management personnel, for whom competition is intense. From time to time, we also employ independent contractors to support our professional services, product development, sales, marketing and business development organizations. Our employees are not represented by any collective bargaining unit, and we have never experienced a work stoppage. We believe our relations with our employees are good.

RISK FACTORS THAT MAY AFFECT RESULTS

This annual report contains forward-looking statements, including statements about our growth and future operating results. For this purpose, any statement that is not a statement of historical fact should be considered a forward-looking statement. We often use the words believes, anticipates, plans, expects, intends and similar expressions to help identify forward-looking statements.

There are a number of important factors that could cause our actual results to differ materially from those indicated or implied by forward-looking statements. Factors that could cause or contribute to such differences include those discussed below, as well as those discussed elsewhere in this annual report.

Risks Related To Our Business

We may not be able to sustain or increase our revenue or attain profitability on a quarterly or annual basis.

We incurred a loss in each quarter of fiscal 2002. As of December 31, 2002, we had an accumulated deficit of $199.9 million. Our revenues decreased 28% to $101.5 million in 2002 from $140.3 million in 2001. In addition, we believe the current economic downturn within the software industry could continue to have an adverse effect on demand for our products and services, and therefore adversely affect our revenues as well. Because we have a limited operating history, and operate in a rapidly evolving industry, we have difficulty predicting our future operating results and we cannot be certain that our revenues will grow or our expenses will decrease at rates that will allow us to achieve profitability on a quarterly or annual basis. Additionally, the slowdown in the software industry and the decrease in spending by companies in our target markets have reduced the rate of growth of the Internet as a channel for consumer branded retail and financial services companies. If current economic conditions continue for an extended period of time or worsen, we may experience additional adverse effects on our revenue, net income and cash flows.

If we are unable to reduce our lease obligations, we will incur significant cash expenditures that may impact our cash resources.

We currently have significant lease payment obligations related to our property lease agreements in numerous jurisdictions. We have engaged in ongoing negotiations with our landlords in an effort to reduce these costs with limited success. These negotiations have included attempts to reduce payments on occupied premises and efforts to negotiate buyouts of existing leases on unoccupied premises. We cannot assure you that these activities will be implemented without delay, if ever. In addition, we are currently engaged in litigation over leased premises in Germany as described in Item 3. Legal Proceedings. We cannot assure you that we will not be subject to additional legal proceedings related to our leases. If we are unable to reduce our lease obligations, we will incur significant cash expenditures, which will decrease our cash reserves and may divert cash resources that we intend to utilize in implementing our business strategy.

We expect our revenues and operating results to fluctuate, and the price of our common stock could fall if quarterly results are lower than the expectations of securities analysts.

Our revenues and operating results are likely to vary significantly from quarter to quarter. If our quarterly results fall below our expectations and those of securities analysts, the price of our common stock could fall. A number of factors are likely to cause variations in our operating results, including:

fluctuating economic conditions, particularly as they affect our customers willingness to implement new e-commerce solutions;

the timing of sales of our products and services;

the timing of customer orders and product implementations;

delays in introducing new products and services;

increased expenses, whether related to sales and marketing, product development or administration;

the mix of revenues derived from products and services;

timing of hiring and utilization of services personnel;

cost overruns related to fixed-price services projects;

the mix of domestic and international sales; and

costs related to possible acquisitions of technologies or businesses.

Accordingly, we believe that quarter-to-quarter comparisons of our operating results are not necessarily meaningful. The results of one or a series of quarters should not be relied upon as an indication of our future performance.

We may encounter disruptions to our operations or sales as a result of turnover in management and/or our sales force.

Members of our senior management team, including our two founders, our former Chief Executive Officer and President and other senior managers, have left us during the past two years for a variety of reasons and we cannot assure you that there will not be additional departures. Key members of the current management team, including Robert Burke, our Chief Executive Officer and President who joined us in December 2002, have had limited experience working together and may be unsuccessful in developing or executing on a business strategy for us. These changes in management, and any future similar changes, may be disruptive to our operations. An important part of our total compensation program for management includes stock options. The volatility or lack of positive performance of our stock price may from time to time adversely affect our ability to retain our management team.

In addition, we continue to rely heavily on our direct sales force. We have recently restructured and reduced the size of our sales force. Changes in the structure of the sales force have generally resulted in temporary lack of focus and reduced productivity.

Our lengthy sales cycle makes it difficult to predict our quarterly results.

Our long sales cycle, which can range from several weeks to several months or more, makes it difficult to predict the quarter in which sales may occur. We have a long sales cycle because we generally need to educate potential customers regarding the use and benefits of our products and services. Our sales cycle varies depending on the size and type of customer contemplating a purchase and whether we have conducted business with a potential customer in the past. In addition, we believe the current economic downturn in the

United States has increased the average length of our sales cycle as customers have deferred implementing new e-commerce solutions.

We may incur significant sales and marketing expenses in anticipation of licensing our products, and if we do not achieve the level of revenues we expected, our operating results will suffer and our stock price may decline. These potential customers frequently need to obtain approvals from multiple decision makers prior to making purchase decisions. Delays in sales could cause significant variability in our revenues and operating results for any particular period.

Competition could materially and adversely affect our ability to obtain revenues from license fees from new or existing customers and professional services revenues from existing customers. Further, competitive pressures could require us to reduce the price of our software products. In either case, our business, operating results and financial condition would be materially and adversely affected.

The market for Internet online marketing, sales, and service applications is intensely competitive, and we expect competition to intensify in the future.

The market for online marketing, sales and services applications is intensely competitive, and we expect competition to intensify in the future. This level of competition could reduce our revenues and result in increased losses or reduced profits. Our primary competition currently comes from in-house development efforts by potential customers or partners, as well as from other vendors of Web-based application software. We currently compete with Internet application software vendors such as BroadVision. We also compete with platform application server products and vendors such as BEA Systems, IBM s Websphere products, and Microsoft, among others. In addition, we compete indirectly with portal software vendors such as Vignette (through their acquisition of Epicentric), SAP Portals, a subsidiary of SAP, and Plumtree and customer relationship management vendors such as Siebel and Peoplesoft.

Many of our competitors have longer operating histories and significantly greater financial, technical, marketing and other resources than we do, and may be able to respond more quickly to new or changing opportunities, technologies and customer requirements. Also, many current and potential competitors have greater name recognition and more extensive customer bases that they can use to gain market share. These competitors may be able to undertake more extensive promotional activities, adopt more aggressive pricing policies and offer more attractive terms to purchasers than we can. Moreover, our current and potential competitors, such as Microsoft, may bundle their products in a manner that may discourage users from purchasing our products. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to enhance their products and expand their markets. Accordingly, new competitors or alliances among competitors may emerge and rapidly acquire significant market share.

Competition could materially and adversely affect our ability to obtain revenues from license fees from new or existing customers and professional services revenue from existing customers. Further, competitive pressures could require us to reduce the price of our software products. In either case, our business, operating results and financial condition would be materially and adversely affected.

If we fail to maintain our existing customer base, our ability to generate revenues will be harmed.

Historically, we have derived a significant portion of our revenues from existing customers that purchase our support and maintenance services and enhanced versions of our products. Retention of our existing customer base requires that we provide high levels of customer service and product support in order to help our customers maximize the benefits that they derive from our products. In order to compete, we must introduce enhancements and new versions of our products that provide additional functionality. Further, we must manage the transition from our older products so as to minimize the disruption to our customers caused by such migration and integration with the customers information technology platform. If we are unable to continue to obtain significant revenues from our existing customer base, our ability to grow our business would be harmed and our competitors could achieve greater market share.

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We depend on our relationships with systems integrators.

Since our potential customers often rely on third-party systems integrators to develop, deploy and manage Web sites for conducting commerce on the Internet, we cultivate relationships with systems integrators in order to encourage them to support our products. If we do not adequately train a sufficient number of systems integrators or if systems integrators were to devote their efforts to integrating or co-selling different products, our revenues could be reduced and our operating results could be harmed.

We depend on our relationships with value added resellers.

We license products through value added resellers and encourage them to service and support our products. In we are unable to find qualified resellers, are unable to convince qualified resellers to license our products to end users, fail to adequately train a sufficient number of resellers or if resellers choose to devote their efforts to reselling our competitor s products, our revenues could be reduced and our operating results could be harmed.

Competition with our resellers could limit our sales opportunities and jeopardize these relationships.

We sell products through resellers and original equipment manufacturers. In some instances, we target our direct selling efforts toward markets that are also served by some of these partners. This competition may limit our ability to sell our products and services directly in these markets and may jeopardize, or result in the termination of, these relationships.

We could incur substantial costs protecting our intellectual property from infringement or defending against a claim of infringement.

Our professional services often involve the development of custom software applications for specific customers. In some cases, customers retain ownership or impose restrictions on our ability to use the technologies developed from these projects. Issues relating to the ownership of software can be complicated, and disputes could arise that affect our ability to resell or reuse applications we develop for customers.

We seek to protect the source code for our proprietary software both as a trade secret and as a copyrighted work. However, because we make the source code available to some customers, third parties may be more likely to misappropriate it. Our policy is to enter into confidentiality agreements with our employees, consultants, vendors and customers and to control access to our software, documentation and other proprietary information. Despite these precautions, it may be possible for someone to copy our software or other proprietary information without authorization or to develop similar software independently.

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights. We could incur substantial costs to prosecute or defend any intellectual property litigation. If we sue to enforce our rights, the litigation would be expensive, would divert management resources and may not prevent other parties from using our intellectual property without our permission. In February 2000, we settled a lawsuit filed by BroadVision, which alleged that we were infringing on a patent for a method of conducting e-commerce. As part of the settlement, we agreed to pay BroadVision a total of $15.0 million in license fees over a three-year period, which was completed as of December 31, 2002.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. Policing unauthorized use of our products is difficult and while we are unable to determine the extent to which piracy of our software exists, software piracy can be expected to be a persistent problem. Litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement or invalidity. However, the laws of many countries do not protect proprietary rights to as great an extent as the laws of the United States. Any such resulting litigation could result in substantial costs and diversion of resources and could have a material adverse effect on our business, operating results and financial condition. There can be no assurance that our means of protecting our proprietary rights will be adequate or that our competitors will not independently

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develop similar technology. Any failure by us to meaningfully protect our property could have a material adverse effect on our business, operating results and financial condition.

In addition, we have agreed to indemnify customers against claims that our products infringe the intellectual property rights of third parties. The results of any intellectual property litigation to which we might become a party may force us to do one or more of the following:

- cease selling or using products or services that incorporate the challenged intellectual property;
- obtain a license, which may not be available on reasonable terms, to sell or use the relevant technology; or
- redesign those products or services to avoid infringement.

If we fail to adapt to rapid changes in the market for Internet online marketing, sales, and service applications, our existing products could become obsolete.

The market for our products is marked by rapid technological change, frequent new product introductions and Internet-related technology enhancements, uncertain product life cycles, changes in customer demands, coalescence of product differentiators, and evolving industry standards. We may not be able to develop and market or acquire new products or product enhancements that comply with present or emerging Internet technology standards and to differentiate our products based on functionality and performance. In addtion, we may not be able to establish strategic alliances with operating system and infrastructure vendors that will permit migration opportunities for our current user base. New products based on new technologies or new industry standards could render our existing products obsolete and unmarketable. For example, functionality that once differentiated our products over time has been incorporated into products offered by the major operating system and infrastructure providers. To succeed, we will need to enhance our current products and develop new products on a timely basis to keep pace with developments related to Internet technology and to satisfy the increasingly sophisticated requirements of customers. E-commerce technology is complex and new products and product enhancements can require long development and testing periods. Any delays in developing and releasing new or enhanced products could cause us to lose revenue opportunities and customers.

Our business may suffer if we fail to address the challenges associated with international operations.

As of December 31, 2002 we had offices in Australia, Canada, England, France, Germany, Japan, the Netherlands, and Sweden. We derived 30% of our total revenues from customers outside the United States for the year ending December 31, 2002. In December 2002, we initiated a restructuring plan, which included the closing of our offices in Australia, Canada, and the Netherlands at varying times during the first quarter of 2003. Our operations outside North America are subject to additional risks, including:

- changes in regulatory requirements, exchange rates, tariffs and other barriers;
- longer payment cycles and problems in collecting accounts receivable;
- political and economic instability;
- difficulties in managing systems integrators and technology partners;
- difficulties in staffing and managing foreign subsidiary operations;
- differing technology standards;
- difficulties and delays in translating products and product documentation into foreign languages;
- reduced protection for intellectual property rights in some of the countries in which we operate or plan to operate; and
- potentially adverse tax consequences.

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The impact of future exchange rate fluctuations on our operating results cannot be accurately predicted. We may increase the extent to which we denominate arrangements with international customers in the currencies of the countries in which the software or services are provided. From time to time we may engage in hedges of a significant portion of contracts denominated in foreign currencies. Any hedging policies implemented by us may not be successful, and the cost of these hedging techniques may have a significant negative impact on our operating results.

Our software products may contain errors or defects that could result in lost revenues, delayed or limited market acceptance, or product liability claims with substantial litigation costs.

Complex software products such as ours often contain errors or defects, particularly when first introduced or when new versions or enhancements are released. We began shipping the latest version of ATG 6.0 suite of products, in the fourth quarter of 2002. Despite internal testing and testing by customers, our current and future products may contain serious defects. Serious defects or errors could result in lost revenues or a delay in market acceptance.

Since our customers use our products for critical business applications such as e-commerce, errors, defects or other performance problems could result in damage to our customers. They could seek significant compensation from us for the losses they suffer. Although our license agreements typically contain provisions designed to limit our exposure to product liability claims, existing or future laws or unfavorable judicial decisions could negate these limitations. Even if not successful, a product liability claim brought against us would likely be time-consuming and costly.

If we acquire other companies or businesses, we will be subject to risks that could hurt our business.

We acquired Petronio Technology Group in May 2000 for approximately $1.2 million and Toronto Technology Group Inc. in July 2000 for approximately $12.0 million. These acquisitions did not produce the revenues and synergies we expected. We incurred approximately $5.3 million in restructuring charges during the year ended December 31, 2001 related to the write off of unamortized goodwill and the settlement of restricted stock in connection with these acquisitions. In addition, we also incurred additional restructuring charges during the year ended December 31, 2001 in reducing headcount related to the Toronto Technology Group Inc. acquisition.

In the future, we may pursue additional acquisitions to obtain complementary businesses, products, services or technologies. An acquisition may not produce the revenues, earnings or business synergies that we anticipated, and an acquired business, product, service or technology might not perform as we expected. If we pursue an acquisition, our management could spend a significant amount of time and effort in identifying and completing the acquisition. If we complete an acquisition, we may encounter significant difficulties and incur substantial expenses in integrating the operations and personnel of the acquired company into our operations while preserving the goodwill of the acquired company. In particular, we may lose the services of key employees of the acquired company and we may make changes in management that impair the acquired company s relationships with employees and customers.

Any of these outcomes could prevent us from realizing the anticipated benefits of our acquisitions. To pay for an acquisition, we might use stock or cash. Alternatively, we might borrow money from a bank or other lender. If we use our stock, our stockholders would experience dilution of their ownership interests. If we use cash or debt financing, our financial liquidity would be reduced. We may be required to capitalize a significant amount of intangibles, including goodwill, which may lead to significant amortization charges. In addition, we may incur significant, one-time write-offs and amortization charges. These amortization charges and write-offs could decrease our future earnings or increase our future losses.

Our announced restructurings may not result in the reduced cost structure we anticipate and may have other adverse impacts on productivity.

In January 2003, we announced a corporate restructuring involving a workforce reduction of approximately 125 people, or 23% of our workforce, which was focused in our professional services, general and

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administrative staff and internal sales and operations, and the closing and consolidation of office facilities in selected locations. These actions resulted in recording a restructuring charge of approximately $19.1 million, in the fourth quarter of 2002. In addition, we recorded a restructuring charge of $76.9 million in 2001 relating to previous restructuring activities. These restructuring activities require that we close facilities, maintain sales efforts and provide continuing customer support and service in regions where the sales and support staff has been reduced or eliminated, reallocate workload among continuing employees, and seek to reduce liability for idle lease space. The outcomes of such restructuring activities are difficult to predict. While we believe our restructuring and consolidation activities will reduce our cost structure, we may not achieve the cost reductions that we are expecting. In addition, our restructuring activities may result in lower revenues as a result of the decreased staff in our sales and marketing and professional services groups or other adverse impacts on productivity that we did not anticipate.

We use the Java programming language to develop our products, and our business could be harmed if Java loses market acceptance or if we are not able to continue using Java or Java-related technologies.

We write our software in the Java computer programming language developed by Sun Microsystems and we incorporate J2EE, Java Runtime Environment, Java Naming and Directory Interface, Java Servlet Development Kit, Java Foundation Classes, JavaMail and JavaBeans Activation Framework into our products under licenses granted to us by Sun. Our ATG 6.0 Relationship Management Platform has been designed to support Sun s J2EE standards. If Sun were to decline to continue to allow us to use these technologies for any reason, we would be required to (a) license the equivalent technology from another souce, (b) rewrite the technology ourselves, or (c) rewrite portions of our software to accommodate the change or no longer use the technology.

While a number of companies have introduced Web applications based on Java, Java could fall out of favor, and support by Sun Microsystems or other companies could decline. Moreover, our new ATG 6.0 Relationship Management Platform is designed to support Sun s Java 2 Platform, Enterprise Edition, or J2EE, standards for developing modular Java programs that can be accessed over a network. We have licensed the J2EE brand and certification tests from Sun. There can be no assurance that these standards will be widely adopted, that we can continue to support J2EE standards established by Sun from time to time or that the J2EE brand will continue to be made available to us on commercially reasonable terms. If Java or J2EE support decreased or we could not continue to use Java or related Java technologies or to support J2EE, we might have to rewrite the source code for our entire product line to enable our products to run on other computer platforms. Also, changes to Java or J2EE standards or the loss of our license to the J2EE brand could require us to change our products and adversely affect the perception of our products by our customers. If we were unable to develop or implement appropriate modifications to our products on a timely basis, we could lose revenue opportunities and our business could be harmed.

We may need additional financing in the future, and any additional financing may result in restrictions on our operations or substantial dilution to our stockholders.

We may need to raise additional funds in the future, for example, to develop new technologies, support an expansion, respond to competitive pressures, acquire complementary businesses or respond to unanticipated situations. We may try to raise additional funds through public or private financings, strategic relationships or other arrangements. Our ability to obtain debt or equity funding will depend on a number of factors, including market conditions, our operating performance and investor interest. Additional funding may not be available to us on acceptable terms or at all. If adequate funds are not available, we may be required to revise our business plan to reduce expenditures, including curtailing our growth strategies, foregoing acquisitions or reducing our product development efforts. If we succeed in raising additional funds through the issuance of equity or convertible securities, the issuance could result in substantial dilution to existing stockholders. If we raise additional funds through the issuance of debt securities or preferred stock, these new securities would have rights, preferences and privileges senior to those of the holders of our common stock. The terms of these securities, as well as any borrowings under our credit agreement, could impose restrictions on our operations.

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Risks Related To The Internet Industry

Our performance will depend on the growth of e-commerce and self-service.

Our success will depend heavily on the continued use of the Internet for e-commerce. The current United States economic downturn has reduced demand for our products as customers and potential customers delay or cancel the implementation of online marketing, sales, and service applications. If the market for our products and services does not continue to mature, we will be unable to execute successfully our business plan. Adoption of electronic commerce and online marketing, sales, and service applications, particularly by those companies that have historically relied upon traditional means of commerce, will require a broad acceptance of different methods of conducting business. Our future revenues and profits will substantially depend on the Internet being accepted and widely used for commerce and communication. If Internet commerce does not continue to grow or grows more slowly than expected, our future revenues and profits may not meet our expectations or those of analysts. Similarly, purchasers with established patterns of commerce may be reluctant to alter those patterns or may otherwise resist providing the personal data necessary to support our consumer profiling capability.

Regulations could be enacted that either directly restrict our business or indirectly impact our business by limiting the growth of e-commerce.

As e-commerce evolves, federal, state and foreign agencies could adopt regulations covering issues such as user privacy, content and taxation of products and services. If enacted, government regulations could limit the market for our products and services or could impose burdensome requirements that render our business unprofitable. Although many regulations might not apply to our business directly, we expect that laws regulating the solicitation, collection or processing of personal and consumer information could indirectly affect our business. The Telecommunications Act of 1996 prohibits certain types of information and content from being transmitted over the Internet. The prohibition s scope and the liability associated with a violation are currently unsettled. In addition, although substantial portions of the Communications Decency Act were held to be unconstitutional, we cannot be certain that similar legislation will not be enacted and upheld in the future. It is possible that legislation could expose companies involved in e-commerce to liability, which could limit the growth of e-commerce generally. Legislation like the Telecommunications Act and the Communications Decency Act could dampen the growth in Web usage and decrease its acceptance as a medium of communications and commerce.

The Internet is generating privacy concerns that could result in legislation or market perceptions that could harm our business or result in reduced sales of our products, or both.

Businesses use our ATG Scenario Personalization product to develop and maintain profiles to tailor the content to be provided to Web site visitors. When a visitor first arrives at a Web site, our software creates a profile for that visitor. If the visitor registers or logs in, the visitor s identity is added to the profile, preserving any profile information that was gathered up to that point. ATG Scenario Personalization product tracks both explicit user profile data supplied by the user as well as implicit profile attributes derived from the user s behavior on the Web site. Privacy concerns may cause visitors to resist providing the personal data or avoid Web sites tracking the Web behavioral information necessary to support this profiling capability. More importantly, even the perception of security and privacy concerns, whether or not valid, may indirectly inhibit market acceptance of our products. In addition, legislative or regulatory requirements may heighten these concerns if businesses must notify Web site users that the data captured after visiting Web sites may be used to direct product promotion and advertising to that user. Other countries and political entities, such as the European Economic Community, have adopted such legislation or regulatory requirements. The United States may adopt similar legislation or regulatory requirements. If privacy legislation is enacted or consumer privacy concerns are not adequately addressed, our business, financial condition and operating results could be harmed.

Our products use cookies to track demographic information and user preferences. A cookie is information keyed to a specific user that is stored on a computer s hard drive, typically without the user s

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knowledge. Cookies are generally removable by the user, although removal could affect the content available on a particular site. Germany has imposed laws limiting the use of cookies, and a number of Internet commentators and governmental bodies in the United States and other countries have urged passage of laws limiting or abolishing the use of cookies. If such laws are passed or if users begin to delete or refuse cookies as a common practice, demand for our personalization products could be reduced.

Risks Related To The Securities Markets And Our Stock

Our stock price may continue to be volatile.

The market price of our common stock has fluctuated in the past and is likely to continue to be highly volatile. For example, the market price of our common stock has ranged from $.58 per share to $126.88 per share since our initial public offering in July 1999. Fluctuations in market price and volume are particularly common among securities of Internet and software companies. The market price of our common stock may fluctuate significantly in response to the following factors, some of which are beyond our control:

- variations in our quarterly operating results;
- changes in market valuations of Internet and software companies;
- our announcements of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
- our failure to complete significant sales;
- additions or departures of our key personnel;
- future sales of our common stock; or
- changes in financial estimates by securities analysts.

We may incur significant costs from class action litigation.

We currently are the subject of securities class action litigation. If a court awards damages to the plaintiffs, the total amount could exceed the limit of our existing insurance. This litigation also may divert management s attention and resources. We may be the target of similar litigation in the future if the market for our stock becomes volatile. For a further description of the pending litigation, see Item 3. Legal Proceedings.

Anti-takeover provisions in our charter documents and Delaware law could prevent or delay a change in control of our company.

Certain provisions of our charter and by-laws may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable, which could reduce the market price of our common stock. These provisions include:

- authorizing the issuance of blank check preferred stock;
- providing for a classified board of directors with staggered, three-year terms;
- providing that directors may only be removed for cause by a two-thirds vote of stockholders;
- limiting the persons who may call special meetings of stockholders prohibiting stockholder action by written consent;
- establishing advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted on by stockholders at stockholder meetings; and
- authorizing anti-takeover provisions.

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In addition, we adopted a shareholder rights plan in 2001 and Delaware law may further discourage, delay or prevent someone from acquiring or merging with us.

Item 2. ***Properties***

Our principal administrative, research and development, sales, consulting, training and support facilities occupy approximately 91,000 square feet in Cambridge, Massachusetts, pursuant to leases expiring through 2007. Our west coast headquarters occupy approximately 40,000 square feet in San Francisco, California pursuant to a lease expiring in 2011. Our European headquarters are located in Apex Plaza, Reading UK where we lease approximately 15,600 square feet pursuant to a lease expiring in 2009. Our Asia Pacific headquarters are located in North Sydney, Australia where we currently lease 8,600 square feet pursuant to a lease expiring in 2003. Our German headquarters are located in Frankfurt, Germany where we currently lease 38,500 square feet pursuant to a lease expiring in 2007.

At December 31, 2002, we also had offices in Australia, Canada, France, Japan, the Netherlands and Sweden. During 2002 and 2001, we undertook plans to restructure our operations, which included the closing of our offices in Australia, Canada and the Netherlands at various times during the first quarter of 2003. In addition, these restructurings included the abandonment of approximately 30,500 square feet of our Cambridge, Massachusetts s headquarters, 3,000 square feet of our San Francisco, California headquarters, and all of the square footage in Frankfurt, Germany, and North Sydney, Australia. All of these locations have been released for sub-lease and we are also pursuing termination arrangements with our landlords.

For further information concerning our lease restructuring activities and concerning our obligations under all operating leases, see Note 11 and Note 7, respectively, of the Notes to our Consolidated Financial Statements contained in Item 8 of this Annual Report on Form 10-K.

Item 3. ***Legal Proceedings***

We [and certain officers] have been named defendants in seven purported class action suits currently pending in the United States District Court for the District of Massachusetts. Each of these cases alleges that we [and the named officers] have violated Sections 10(b) and 20(a) of the Securities Exchange Act and SEC Rule 10b-5, which generally may subject issuers of securities and persons controlling those issuers to civil liabilities for fraudulent actions or defects in the public disclosure required by securities laws. Four of the cases were filed on various dates in October 2001 in the U.S. District Court for the District of Massachusetts. Three of the cases were initially filed in the Central District of California on various dates in August and September 2001. These three California actions were consolidated and transferred to the District of Massachusetts on or about November 27, 2001. On December 13, 2001, the Court issued an Order of Consolidation in which it consolidated all actions filed against us and appointed certain individuals as lead plaintiffs in the consolidated action. It also appointed two law firms as co-lead counsel, and a third law firm as liaison counsel. Counsel for the plaintiffs has filed a Consolidated Amended Complaint applicable to all of the consolidated actions. On April 19, 2002 we filed a motion to dismiss the case. The plaintiffs have filed their opposition to the motion, and we have submitted a response. While management believes the claims against us are without merit and intends to defend the action vigorously, the litigation is in the preliminary stage.

A breach of contract claim was filed in Germany by DIFA Deutsche Immobilien Fonds AG against Art Technology Group GMBH, a subsidiary of the Company, on July 18, 2002. The suit alleges that ATG GmbH failed to pay rent on office space leased by the plaintiff and failed to deliver a bank guarantee, thereby breaching its lease obligations to plaintiff. The German court returned a ruling on January 22, 2003 adverse to ATG and found in favor of the plaintiff in the approximate amount of 1.4 million euros (approximately $1,486,000 as of March 21, 2003) plus 8% interest and the delivery of a security deposit in the form of a bank guarantee in the amount of approximately 675,000 euros (approximately $717,000 as of March 21, 2003). The judgment amount represents unpaid rent from February to June 2002, which was accrued as part of the restructuring charges recorded in 2001 and remains accrued at December 31, 2002. At the plaintiff s option, it may seek to institute suit in the future for additional rents that have accrued since the date established in the ruling. The prevailing party in a German lawsuit is also entitled to collect court costs and attorneys fees from the non-prevailing party according to a fee and cost schedule established by law. The fees and costs in this case total approximately 65,000 euros (approximately $69,000 as of March 21, 2003), (exclusive of fees and costs associated with a potential appeal). ATG filed an appeal to the suit on February 6, 2003. ATG s appeal of the suit is based, in part, on interpretations of law made by the first judge relating to alleged modifications to the original agreement with plaintiff.

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

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

None.

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PART II

Item 5. ***Market for the Registrant s Common Equity and Related Stockholder Matters***

Our common stock trades on the Nasdaq National Market under the symbol ARTG. The following table sets forth the high and low reported sales prices of our common stock for the periods indicated as reported by the Nasdaq National Market.

	High	Low
Year ending December 31, 2001		
First quarter	$43.94	$15.86
Second quarter	12.16	4.05
Third quarter	5.22	0.65
Fourth quarter	4.72	0.58
Year ending December 31, 2002		
First quarter	$ 5.15	$ 1.85
Second quarter	2.30	0.78
Third quarter	1.30	0.85
Fourth quarter	1.84	0.86

On March 21, 2003 the last reported sale price on the Nasdaq National Market for our common stock was $0.90 per share. On March 21, 2003, there were approximately 20,000 holders of record of our common stock.

We currently intend to retain future earnings, if any, to finance our growth. We do not anticipate paying cash dividends on our common stock in the foreseeable future. Payment of future dividends, if any, will be at the discretion of our board of directors after taking into account various factors, including our financial condition, operating results, current and anticipated cash needs, restrictions in financing agreements and plans for expansion.

Item 6. ***Selected Financial Data***

Consolidated Statements of Operations Data:

	Year Ended December 31,				
	1998(1)	1999(1)	2000	2001	2002
	(In thousands, except per share data)				
Revenues:					
Product license	$ 4,059	$18,590	$121,525	$ 76,631	$ 48,796
Services	8,078	13,487	42,917	63,707	52,697
Total revenues	12,137	32,077	164,442	140,338	101,493
Cost of Revenues:					
Product licenses	30	8,160	3,426	4,616	4,278
Services	5,020	10,232	35,839	47,361	33,441
Total cost of revenues	5,050	18,392	39,265	51,977	37,719
Gross profit	7,087	13,685	125,177	88,361	63,774

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	Year Ended December 31,				
	1998(1)	1999(1)	2000	2001	2002
	(In thousands, except per share data)				
Operating Expenses:					
Research and development	3,355	6,343	18,966	30,119	21,717
Sales and marketing	4,074	15,921	73,261	93,186	42,913
General and administrative	2,291	5,323	22,791	23,952	10,987
Amortization of deferred compensation	107	1,127	1,273	1,280	942
Restructuring				76,945	19,005
Total operating expenses	9,827	28,714	116,291	225,482	95,564
Income (loss) from operations	(2,740)	(15,029)	8,886	(137,121)	(31,790)
Interest and other income, net	(111)	1,897	8,979	4,967	2,300
Net income (loss) before provision for income taxes	(2,851)	(13,132)	17,865	(132,154)	(29,490)
Provision for income taxes			3,378	23,851	
Net income (loss)	(2,851)	(13,132)	14,487	(156,005)	(29,490)
Accretion of Dividends, Discount and Offering Costs on Preferred Stock	(1,594)	(4,395)			
Net income (loss) available for common stockholders	$ (4,445)	$ (17,527)	$ 14,487	$ (156,005)	$ (29,490)
Net income (loss) per share:					
Basic	$ (0.25)	$ (0.45)	$ 0.22	$ (2.27)	$ (0.42)
Diluted	$ (0.25)	$ (0.45)	$ 0.20	$ (2.27)	$ (0.42)
Weighted average common shares outstanding:					
Basic	17,394	38,777	66,932	68,603	69,921
Diluted	17,394	38,777	73,138	68,603	69,921

(1) Reimbursement of out-of-pocket expenses for 1998 and 1999 have not been reclassified and included in revenue and cost of services as required by EITF 01-14 because we cannot readily obtain the appropriate information. We do not expect the reclass of these amounts to be material.

Consolidated Balance Sheet Data:

	December 31,				
	1998	1999	2000	2001	2002
Cash, cash equivalents and short term marketable securities	$ 4,093	$ 129,848	$ 126,473	$ 63,550	$ 68,558
Working capital	3,649	117,727	122,422	37,993	37,966

Restricted cash				16,757	
Long-term marketable securities		19,394	17,734		
Total assets	7,766	177,735	259,515	137,488	106,862
Long-term obligations, less current maturities	322	4,000	2,000		
Redeemable convertible preferred stock	8,313				
Total stockholders equity (deficit)	(4,034)	146,385	191,973	42,909	16,023

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

Overview

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes contained in Item 8 of this Annual Report on Form 10-K. This discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of a number of factors, including those set forth under Item 1. Business Risk Factors that May Affect Results and elsewhere in this report.

We were founded in December 1991. From 1991 through 1995, we devoted our efforts principally to building, marketing and selling our professional services capabilities and to research and development activities related to our software products. Beginning in 1996, we began to focus on selling our software products.

To date, we have enhanced and released several versions of our products. We market and sell our products worldwide through our direct sales force, systems integrators, technology alliances and original equipment manufacturers.

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

We recognize revenue in accordance with Statement of Position (SOP) 97-2, *Software Revenue Recognition* and SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*. Revenues from software product license agreements are recognized upon execution of a license agreement and delivery of the software, provided that the fee is fixed or determinable and deemed collectible by management. If conditions for acceptance are required subsequent to delivery, revenues are recognized upon customer acceptance if such acceptance is not deemed to be perfunctory. In multiple element arrangements, we use the residual value method in accordance with SOP 97-2 and SOP 98-9. Revenue earned on software arrangements involving multiple elements which qualify for separate element accounting treatment is allocated to each undelivered element using the relative fair values of those elements based on vendor specific objective evidence with the remaining value assigned to the delivered element, the software license. Typically our software licenses do not include significant post-delivery obligations to be fulfilled by us and payments are due within a three-month period from the date of delivery. Consequently, license fee revenue is generally recognized when the product is shipped. Revenues from software maintenance agreements are recognized ratably over the term of the maintenance period, which is typically one year. We enter into reseller arrangements that typically provide for sublicense fees payable to us based upon a percentage of our list price. Revenues are recognized under reseller agreements as earned for guaranteed minimum royalties, generally ratably over one year, or based upon unit sales by the resellers. We do not grant our resellers the right of return or price protection.

Revenues from professional service arrangements are recognized on either a time and materials or percentage-of-completion basis as the services are performed, provided that amounts due from customers are fixed or determinable and deemed collectible by management. Amounts collected prior to satisfying the above revenue recognition criteria are reflected as deferred revenue. Unbilled services represent service revenues that have been earned by us in advance of billings. Deferred revenue primarily consists of advance payments related to support and maintenance and service agreements.

As of December 31, 2002 we had offices in Australia, Canada, England, France, Germany, Japan, the Netherlands, Sweden, and the United States. Revenues from customers outside the United States accounted for 30% of our total revenues in 2002, 34% in 2001 and 23% in 2000. In December 2002, we initiated a restructuring plan, which included the closing of our offices in Australia, Canada, and the Netherlands at varying times during the first quarter of 2003.

Critical Accounting Policies and Estimates

This management s discussion and analysis of financial condition and results of operations discusses 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 management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, management evaluates its estimates and judgments, including those related to revenue recognition, the allowance for doubtful accounts, research and development costs, restructuring expenses, the impairment of long-lived assets and income taxes. Management bases its estimates and judgments on historical experience, known trends or events and various other factors 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 to be both those most important to the portrayal of our financial condition and those that require the most subjective judgment.

Revenue Recognition

Not only is revenue recognition a key component of our results of operations, the timing of our revenue recognition also determines the timing of certain expenses, such as commissions. In measuring revenues, we follow the specific guidelines of SOP 97-2 and SOP 98-9. SOP 97-2 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists via a signed license agreement; (2) physical or electronic delivery has occurred including the availability of license keys or services rendered; (3) the fee is fixed or determinable representing amounts that are due unconditionally with no future obligations under customary payment terms; and (4) collectibility is probable. In addition, revenue results are difficult to predict and any shortfall or delay in recognizing revenue could cause our operational results to vary significantly from quarter to quarter and could result in future operating losses.

Accounts Receivable and Bad Debt

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We continuously monitor collections and payments from our customers and determine the allowance for doubtful accounts based upon historical experience and specific customer collection issues. 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.

Research and Development Costs

We account for research and development costs in accordance with FAS 2, *Accounting for Research and Development Costs* (FAS 2), and FAS 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed* (FAS 86), which specifies that costs incurred internally to develop computer software products should be charged to expense as incurred until technological feasibility is reached for the product. Once technological feasibility is reached, all software costs should be capitalized until the product is made available for general release to customers. Judgment is required in determining when technological feasibility is established. We believe that the time period from reaching technological feasibility until the time of general product release is very short. Costs incurred after technological feasibility is reached are not material, and accordingly, all such costs are charged to research and development expense as incurred.

Restructuring Expenses

During 2002 and 2001, we recorded restructuring charges of $19.0 million and $76.9 million, respectively, pertaining to the closure and consolidation of excess facilities, impairment of assets as discussed below, employee severance benefits, and settling of certain contractual obligations. The charges were recorded in accordance with ETIF 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, FAS 88, *Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* and SAB 100, *(Restructuring and Impairment Charges).* In determining the charges to record, we made certain estimates and judgments surrounding the amounts ultimately to be paid for the actions we have taken. At December 31, 2002, there are various accruals recorded for the costs to exit certain facilities and lease obligations, which may be adjusted periodically for either resolution of certain contractual commitments or changes in estimates of sub-lease income or the period of time the facilities will be vacant and sub-leased. Although we do not anticipate significant changes to our restructuring accruals, the actual costs may differ from those recorded in the event that the subleasing assumptions require adjustment due to changes in economic conditions surrounding the real estate market or we are successful in terminating our lease obligations prior to the scheduled termination date. Such changes could have a material impact to our operating results.

Impairment or Disposal of Long Lived Assets

We review our long-lived assets whenever events or changes in circumstances indicate that the carrying amount of such an asset may not be recoverable. Recoverability of these assets is measured by comparison of their carrying amount to future undiscounted cash flows the assets are expected to generate. If such assets are considered impaired, the impairment to be recognized is equal to the amount by which the carrying value of the assets exceed the fair market value determined by either a quoted market price, if any, or a value determined by utilizing a discounted cash flow technique. In assessing recoverability, we must make assumptions regarding estimated future cash flows and discount factors. If these estimates or related assumptions change in the future, we may be required to record impairment charges.

As a result of our restructuring activities in 2002 and 2001, we evaluated the realizability of our long-lived assets including fixed assets and leasehold improvements related to our restructured facility leases and intangible assets consisting primarily of unamortized goodwill. In 2002, we determined that $1.7 million of furniture and fixtures, computer equipment and software were impaired as a result of our decision to abandon the assets because of the termination of employees and related closures of offices in our 2002 and 2001 restructuring plans.

These assets are no longer being used or will not be used in the future upon completion of the 2002 restructuring plan, which is expected to be substantially complete by the end of the first quarter of 2003. In addition, $909,000 of leasehold improvements were deemed to be impaired due to exiting certain office locations and the estimated sub-lease income was not sufficient to recover the assets carrying value. In 2001, we determined that $7.7 million of leasehold improvements and $2.2 million of furniture, fixtures and equipment were impaired as a result of these restructured operating leases. In addition we determined that approximately $1.4 million of purchased software was impaired due to our revised product development strategy. Lastly we wrote-off the remaining unamortized goodwill of $4.0 million due to the closure and abandonment of two professional service acquisitions completed in fiscal year 2000.

Accounting for Income Taxes

We account for income taxes in accordance with Statement of Financial Accounting Standards No. 109 *Accounting for Income Taxes* (FAS 109) which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded

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assets and liabilities. FAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax assets will not be realized. We evaluate quarterly the realizability of our deferred tax assets by assessing our valuation allowance and by adjusting the amount of such allowance, if necessary.

At December 31, 2002 and 2001, we have provided a full valuation allowance against our deferred tax assets due to the uncertainty of their realizability.

In addition, we have provided for potential amounts due in various foreign tax jurisdictions. Judgment is required in determining our worldwide income tax expense provision. In the ordinary course of global business, there are many transactions and calculations where the ultimate tax outcome is uncertain. Some of these uncertainties arise as a consequence of cost reimbursement arrangements among related entities. Although, we believe our estimates are reasonable, no assurance can be given that the final tax outcome of these matters will not be different than that which is reflected in our historical income tax provisions and accruals. Such differences could have a material impact on our income tax provision and operating results in the period in which such determination is made.

Results of Operations

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

	Year Ended December 31,		
	2002	**2001**	**2000**
Revenues:			
Product license	48%	55%	74%
Services	52	45	26
Total revenues	100	100	100
Cost of revenues:			
Product license	4	3	2
Services	33	34	22
Total cost of revenues	37	37	24
Gross margin	63	63	76
Operating expenses:			
Research and development	21	21	12
Sales and marketing	42	66	45
General and administrative	11	17	14
Stock-based compensation	1	1	1
Restructuring	19	55	
Total operating expenses	94	161	71
Income (loss) from operations	(31)	(98)	5
Interest and other income (expense), net	2	4	5
Income (loss) before provision for income taxes	(29)	(94)	11
Provision for income taxes		17	2
Net income (loss)	(29)%	(111)%	9%

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

	Year Ended December 31,		
	2002	2001	2000
Cost of product license revenues	9%	6%	3%
Cost of services revenues	63	74	84

Years Ended December 31, 2002, 2001 and 2000

Revenues

Total revenues decreased 28% to $101.5 million in 2002 from $140.3 million in 2001. The decrease was primarily attributable to the slowing economy, reduced information technology spending among our customer base, and lengthening of the sales cycle Revenues generated from international customers decreased to $30.1 million, or 30% of total revenues, in 2002, from $47.6 million, or 34% of total revenues, in 2001. We expect total revenues to decrease slightly in 2003 and the international revenues as a percentage of total revenues to be approximately 30%.

Total revenues decreased 15% to $140.3 million in 2001 from $164.4 million in 2000. The decrease was primarily attributable to the slowing economy and reduced information technology spending among our customer base and increased competition from application server software companies. Revenues generated from international customers increased to $47.6 million, or 34% of total revenues, in 2001 from $37.6 million, or 23% of total revenues, in 2000.

No individual customer accounted for more than 10% of total revenues in 2002, 2001, or 2000.

Product License Revenues

Product license revenues decreased 36% to $48.8 million in 2002 from $76.6 million in 2001. The decrease was primarily attributable to the slowing economy, reduced information technology spending among our customer base and the lengthening of the sales cycle. Product license revenues generated from international customers decreased to $15.4 million in 2002 from $26.4 million in 2001. We expect product license revenues to increase slightly as a percent of total revenues and in absolute dollars in 2003.

Product license revenues decreased 37% to $76.6 million in 2001 from $121.5 million in 2000. The decrease was primarily attributable to the slowing economy, reduced information technology spending and the lengthening of the sales cycle. Product license revenues generated from international customers decreased slightly to $26.4 million in 2001 from $27.1 million in 2000.

Product license revenues as a percentage of total revenues for the years ended December 31, 2002, 2001 and 2000 were 48%, 55% and 74%, respectively. We expect this percentage to be between the 50% and 55% in 2003.

Services Revenues

Services revenues decreased 17% to $52.7 million in 2002 from $63.7 million in 2001. The decrease was primarily attributable to the slowing economy, reduced information technology spending, declining product revenue and a reduction in our services capacity as we increased our use of channel partners. Additionally, as a result of lower product sales, support and maintenance revenues and professional services revenues have decreased. We expect services revenues to decrease slightly as a percent of total revenue and to decrease in absolute dollars in 2003.

Support and maintenance revenues were 61% of total service revenues in 2002 as compared to 51% in 2001. However, the increase in absolute dollars from 2001 to 2002 was only $700,000. Support revenues were higher during 2002 due to additional support required by customers migrating to newer versions of ATG

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products. We expect support revenues to decrease in 2003 due to the fact that some customers are decreasing or terminating their support coverage.

Services revenues increased 48% to $63.7 million in 2001 from $42.9 million in 2000. The increase in services revenues was primarily attributable to growth in our services customer base, an increase in the resources of our professional services staff and support renewals resulting from an expanded installed customer base.

Support and maintenance revenues were 51% of total service revenues in 2001 as compared to 40% in 2000. The increase is directly related to the increase in product revenues.

Services revenues as a percentage of total revenues for the years ended December 31, 2002, 2001, and 2000 were 52%, 45% and 26%, respectively. We expect this percentage to be between 45% and 50% in 2003.

Cost of Product License Revenues

Cost of product license revenues decreased 7% to $4.3 million in 2002 from $4.6 million in 2001. This decrease is primarily related to lower product revenues. In February 2000, we settled a lawsuit filed by BroadVision in December 1998, which alleged that we were infringing on a patent for a method of conducting e-commerce. As part of the settlement, we agreed to pay BroadVision a total of $15.0 million in license fees, which are being accounted for as cost of product license revenues. For 2002, approximately half of our cost of product license revenues related to the BroadVision settlement that was fully paid as of December 31, 2002. Accordingly we expect cost of product license revenues to decrease in 2003 as compared with 2002.

Cost of product license revenues increased 35% to $4.6 million in 2001 from $3.4 million in 2000. This increase primarily related to increased compensation and benefit costs associated with sustaining engineering activities. In February 2000, we settled a lawsuit filed by BroadVision in December 1998, which alleged that we were infringing on a patent for a method of conducting e-commerce. As part of the settlement, we agreed to pay BroadVision a total of $15.0 million in license fees, which are being accounted for as cost of product license revenues. For 2001, approximately half of our cost of product license revenues related to the BroadVision settlement.

For 2002, 2001 and 2000, cost of product license revenues as a percentage of total revenues was 4%, 3% and 2%, respectively. We anticipate the cost of product license revenues, as a percentage of total revenues, to be between 2% and 4% in 2003.

Cost of Services Revenues

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

Cost of services revenues decreased 29% to $33.4 million in 2002 from $47.4 million in 2001. The decrease was primarily attributable to a reduction in our professional services workforce. Approximately 45% of the decrease was attributable to decreased compensation costs due to a reduction in our work force. The remaining 55% of the decrease was due to a decrease in operating expenses as a result of our restructuring efforts and cost containment initiatives.

Cost of services revenues increased 32% to $47.4 million in 2001 from $35.8 million in 2000. Approximately 50% of the increase was related to compensation and benefit costs attributable to continued growth in our professional services group resources. Facility and other allocated fixed costs such as rent, depreciation, and telecommunication costs increased by approximately 60%. Travel, entertainment and recruiting costs decreased by approximately 10%.

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For 2002, 2001 and 2000, cost of services revenues as a percentage of total revenues were 33%, 34% and 22%, respectively. We anticipate the cost of services revenues, as a percentage of total revenues, to be in the 30% to 35% range in 2003.

Research and Development Expenses

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

Research and development expenses decreased 28% to $21.7 million in 2002 from $30.1 million in 2001. The decrease was primarily attributable to reduction in our workforce. Approximately 51% of the decrease is related to decreased salaries and related benefits. Approximately 12% of the decrease was due to a reduction in the use of third party contractors. The remaining 37% of the decrease was due to a decrease in operating expenses as a result of our restructuring efforts and cost containment initiatives. In 2003, we expect our research and development costs to decrease slightly as a percent of revenue and in absolute dollars over 2002.

Research and development expenses increased 59% to $30.1 million in 2001 from $19.0 million in 2000. The increase was primarily due to the research and development expenses associated with our ATG 5.5 products and our ATG Portals server which we began shipping in the third quarter of 2001. Approximately 50% of the increase was attributable to compensation and benefits. Approximately 10% of the increase was attributable to use of third party contractors. The remaining 40% increase related primarily to facility and other allocated fixed costs such as rent, depreciation, and telecommunications costs.

For 2002, 2001 and 2000, research and development expenses as a percentage of total revenues were 21%, 21% and 12%, respectively. Based on cost reduction initiatives, we anticipate that research and development expenses as a percentage of total revenues will remain in the 20% to 22% range in 2003.

Sales and Marketing Expenses

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

Sales and marketing expenses decreased 54% to $42.9 million in 2002 from $93.2 million in 2001. The decrease is primarily attributable to cost saving initiatives that resulted from a reduction of our sales and marketing group. Approximately 37% of the decrease was related to a decrease in compensation and benefits costs, and 27% of the decrease was related to a reduction in our marketing and promotional expenses. The remaining 36% was due to a decrease in operating expenses as a result of our restructuring efforts and cost containment initiatives.

Sales and marketing expenses increased 28% to $93.2 million in 2001 from $73.3 million in 2000. Approximately 50% of the increase was due to increased compensation and benefits costs, and the remaining 50% of the increase was related to increased facilities and other allocated fixed costs such as rent, depreciation and telecommunications costs.

For 2002, 2001 and 2000, sales and marketing expenses as a percentage of total revenues were 42%, 66% and 45%, respectively. We expect that sales and marketing expenses in 2003 will be in the range of 38% to 41% as a percentage of total revenues. However sales and marketing expenses can fluctuate as a percentage of total revenues depending on economic conditions, level and timing of global expansion, program spending, the rate at which new sales personnel become productive and the level of revenue.

General and Administrative Expenses

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

General and administrative expenses decreased 54% to $11.0 million in 2002 from $24.0 million in 2001. Approximately 38% of the decrease was related to decreases in compensation and benefit costs, and 12% of the

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decrease was related to a reduction in our professional fees. Approximately 26% of the decrease was attributed to a decrease in recruiting, hiring, travel, training and direct office expenses while, approximately 24% of the decrease was related to a decrease in our provision for doubtful accounts due to favorable collections experience resulting in changes in our estimates of required reserves. We expect general and administrative expenses to trend slightly lower in 2003.

General and administrative expenses increased 5% to $24.0 million in 2001 from $22.8 million in 2000. The increase was primarily related to compensation and benefit costs.

For 2002, 2001 and 2000, general and administrative expenses as a percentage of total revenues were 11%, 17% and 14%, respectively. Due to cost reduction initiatives we anticipate that general and administrative expenses will trend slightly lower as a percentage of total revenues and in absolute dollars in 2003.

Stock-Based Compensation

From the fourth quarter of 1998 through 1999, we had recognized total deferred stock-based compensation within Stockholders Equity of $4.9 million in connection with stock option grants. These amounts represent the difference between the exercise price of certain stock option grants and the deemed fair value for accounting purposes of our common stock at the time of these grants. Additionally, in July 2000, we recorded deferred stock-based compensation of $2.0 million for unvested stock options acquired in connection with the acquisition of the Toronto Technology Group, Inc. The number of these stock options has been reduced due to the recipients of these grants terminating their employment with us. We are amortizing these amounts over the vesting periods of the applicable options.

Stock-based compensation expense decreased 26% to $942,000 in 2002 from $1.3 million in 2001 due to the restructuring activities that took place during 2002 and 2001.

Stock-based compensation expense remained consistent at $1.3 million in 2001 and 2000. We expect stock-based compensation expense to decrease significantly as the period they are expensed over ends in the first quarter of 2003.

Restructuring Expenses

As a result of a global slowdown in information technology spending, ATG undertook plans to restructure its operations during 2001. Actions taken by ATG included: consolidation of excess facilities, a worldwide workforce reduction, the write-off of certain unrealizable assets and settling certain obligations that have no future benefit. In the second quarter ATG recorded a restructuring charge of $44.2 million, and in the fourth quarter of 2001, ATG recorded a restructuring charge of $32.7 million. Total restructuring charges for 2001 totaled $76.9 million.

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The significant components of the 2001 restructuring charge (in thousands):

Restructuring Charges

	Quarter Ended June 30, 2001	Quarter Ended December 31, 2001	Year Ended December 31, 2001	Payments or Write-Offs in Twelve Months Ended December 31, 2001	Accrued Restructuring Charges as of December 31, 2001	2001 Adjustments in Estimate made in Quarter Ended June 20, 2002	2001 Adjustments in Estimate made in Quarter Ended December 31, 2002	Payments or Write-Offs	Accrued 2001 Restructuring Charges as of December 31, 2002
Facilities-related costs and impairments	$38,100	$22,818	$60,918	$ 16,208	$44,710	$ 447	$ 907	$ 9,016	$37,048
Employee severance, benefits and related costs	4,757	3,181	7,938	6,748	1,190			920	270
Asset impairments	212	5,358	5,570	5,570					
Exchangeable share settlement		1,263	1,263	1,263					
Marketing costs	851		851	851		(536)			(536)
Legal and accounting costs	315	90	405	232	173			173	
Total	$44,235	$32,710	$76,945	$ 30,872	$46,073	$ (89)	$ 907	$	$36,782

The facilities-related cost component consisted of idle lease space and termination payments for offices worldwide, which were no longer required due to the reduction in personnel. In determining the facilities-related costs, ATG has estimated the vacancy period and sublease income. A component of the fourth quarter facility-related cost was a change in estimate of the second quarter facility-related restructuring charge. The net change in estimate was an additional charge of $1.5 million in the fourth quarter. Of the $1.5 million charge, a credit of $8.2 million was realized due to the buy out of a lease included in the second quarter charge of $9.3 million, which is being paid ratably over 4.5 years. This credit was offset by an increase of approximately $9.7 million due to updated assumptions, as a result of a market analysis indicating lower sublease rates and longer vacancy periods for two leases provided for in the second quarter. Included in the facility-related costs was the write-off of the abandoned leasehold improvements and fixed assets of $7.7 million and $2.2 million, respectively. These fixed assets were directly related to the restructured excess office facilities.

The employee severance cost component of the restructuring charge was related to reductions in personnel. As part of the restructuring ATG terminated the employment of 530 employees, or 46% of ATG s workforce. Approximately 47% of these employees were from sales and marketing, 22% from services, 19% from general and administrative and 12% from research and development. In addition, ATG settled 11,762 exchangeable shares with a certain employee. Upon settlement, ATG recorded $1.3 million as a charge to restructuring.

The asset impairment-related costs included the write-off of the remaining unamortized goodwill of approximately $4.0 million, which was related to the two professional service acquisitions completed in 2000. In addition, the Company determined that approximately $1.4 million of purchased software was deemed impaired due to ATG s revised product development strategy.

During the second quarter of 2002, ATG recorded a net charge increasing the 2001 restructured lease obligation accruals by $447,000. The Company increased one lease obligation estimate by $1.3 million as a result of adjusting the estimated sublease income and vacancy assumptions due to the continued weakening of the real estate market in that location. Offsetting this increase, ATG recognized a benefit of $853,000 from two other restructured lease obligation accruals due to favorable sublease transactions consummated during the second quarter. This net charge has been offset by the Company receiving a refund of $536,000 relating to the marketing component of the restructuring charge recorded in fiscal 2001, resulting in a net credit to income of $89,000 for the quarter ended June 30, 2002. Also, during the fourth quarter of

2002, ATG recorded a charge of $907,000 to increase charges recorded in 2001 for lease obligations of idle locations.

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As a result of the continued weakness in global information technology spending, ATG undertook plans to restructure its operations during 2002. Actions taken by ATG included: consolidation and closure of excess facilities, a worldwide workforce reduction and the write-down of certain idle assets. In the second quarter ATG recorded a restructuring credit of $89,000, due to a change in the 2001 estimated restructuring charge, and in the fourth quarter of 2002, ATG recorded a restructuring charge of $19.1 million. Total restructuring charges for 2002 totaled $19.0 million.

The significant components of the 2002 restructuring charge (in thousands):

Restructuring Charges

	Quarter Ended December 31, 2002	Payments or Write-Offs for the Twelve Months Ended December 31, 2002	Accrued 2002 Restructuring Charges as of December 31, 2002
Facilities-related costs and impairments	$14,634	$2,613	$12,021
Employee severance, benefits and related costs	3,553		3,553
Total	$18,187	$2,613	$15,574

During the fourth quarter of 2002, the Company recorded a restructuring charge of $19.1 million, which consisted of actions initiated in the fourth quarter of 2002 and an adjustment of $907,000 to increase the charges recorded in 2001 for lease obligations of idle locations. The facilities-related charge associated with the 2002 fourth quarter action was $13,476,000, comprising $12,021,000 for operating leases related to office space that is either idle or will be vacated during the first quarter of 2003 and $1,455,000 of leasehold improvement and furniture and fixtures written down to their estimated fair value. The Company also recorded a charge of $3,553,000 for severance and benefit costs related to cost reduction actions taken across the worldwide employee base, and as a result of this action and the actions taken in 2001, the Company wrote-off $1,158,000 of computer equipment and software, which were no longer being used due to the reduction in personnel and office locations.

The lease charge is for office space the Company is vacating and intends to sub-lease. The amount of the operating lease charge is based on assumptions from current real estate market data for sub-lease income rates and vacancy rates at each respective location. The severance and benefit costs were for 125 employees, or 23% of the Company s workforce, consisting of 53 employees from sales and marketing, 45 from services, 19 from general and administrative and 8 from research and development. The Company accrued employee benefits pursuant to ongoing benefits plans and statutory minimum requirements in foreign locations. The Company began the termination process on January 6, 2003. As a result of a reduction of employees on a worldwide basis in the 2002 and 2001 restructuring actions, as well as the closure of certain office locations, the Company wrote-off computer equipment and software and furniture and fixtures that it has abandoned and will not be used in the future. These assets have been written down to their fair value based on the expected cash flows they will generate over their remaining economic life. Due to the short remaining economic life and current market conditions for such assets, the fair value of these assets has been estimated as zero. In addition, the Company wrote-off leasehold improvements related to the facilities it is attempting to sub-lease because the estimated cash flows to be generated from those locations are not sufficient to recover the carrying value of the assets. The Company expects to substantially complete the above actions by the end of the first quarter of 2003. Once fully complete, we anticipate the restructuring activities will result in annual savings of approximately $12 million to $16 million.

As of December 31, 2002, the Company had an accrued restructuring liability of $52.4 million, of which $36.8 million relates to 2001 restructuring charges and $15.6 million relates to 2002 restructuring charges. The

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long-term portion of the accrued restructuring liability was $32.5 million. A summary of the short and long-term accrued restructuring is as follows (in thousands):

Accrued Restructuring

	Twelve Months Ended December 31, 2001	Payments or Write-offs in the Twelve Months Ended December 31, 2001	Accrued Restructuring Charges as of December 31, 2001	Restructuring Charges for the Twelve Months Ended December 31, 2002	Payments or Write-Offs for the Twelve Months Ended December 31, 2002	Accrued Restructuring Charges as of December 31, 2002
Facilities-related costs and impairments	$60,918	$16,208	$44,710	$15,988	$11,629	$49,069
Employee severance, benefits and related costs	7,938	6,748	1,190	3,553	920	3,823
Asset impairments	5,570	5,570				
Exchangeable share settlement	1,263	1,263				
Marketing costs	851	851		(536)		(536)
Legal and accounting costs	405	232	173		173	
Total	$76,945	$30,872	$46,073	$19,005	$12,722	$52,356

Interest and Other Income, Net

Interest and other income net, decreased 54% to $2.3 million in 2002 from $5.0 million in 2001. The decrease was primarily due to a decrease in our average cash and marketable securities balances in 2002 as compared to 2001, coupled with lower earned interest rates. Offsetting the decrease in interest income in 2002 were gains of $950,000 from foreign currency exchange transactions and the re-measurement of foreign currency denominated assets and liabilities into the functional currency of various subsidiaries. Foreign currency related gains in 2002 increased from $58,000 for the year ended December 31, 2001.

Interest income decreased 45% to $5.0 million in 2001 from $9.0 million in 2000. The decrease was primarily due to a decrease in our average cash and marketable securities balances in 2001 as compared to 2000, coupled with lower earned interest rates.

Provision for Income Taxes

As a result of net operating losses incurred in 2002 and 2001, and after evaluating our anticipated performance over our normal planning horizon, we have provided a full valuation allowance for our net operating loss carryforwards and other net deferred tax assets. Due to the uncertainty surrounding the utilization of our net deferred tax assets, net operating losses and research credits carryforwards, we have recorded a 100% valuation allowance. The provision in 2001 includes a $54.9 million charge recorded in the fourth quarter to reverse income tax benefits recognized in the first three quarters of 2001 and to establish a valuation allowance against our net deferred tax assets due to a change in our assessment of the realizability of these assets.

Liquidity and Capital Resources

Our capital requirements relate primarily to facilities, employee infrastructure and working capital requirements. Historically, we have funded our cash requirements primarily through the public and private sales of equity securities, commercial credit facilities and capital leases. In 2002, we also funded our cash requirements in part from operations. At February 28, 2003, we had $50.2 million in cash and cash equivalents and $15.0 million in marketable securities.

Cash used in operating activities was $13.2 million in 2002. This consisted of operating losses of $29.5 million, a decrease in accounts receivable of $5.3 million, an increase in accrued restructuring of $6.8 million and depreciation and amortization of $7.1 million. Other changes in working capital items consisted primarily of $8.5 million in cash used for accrued expenses and a decrease in deferred revenues.

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Cash used in operating activities was $54.6 million in 2001. This consisted of operating losses of $156.0 million, which was offset by reductions in accounts receivable of $21.9 million, deferred income taxes of $23.9 million, an increase in accrued restructuring of $42.7 million, and depreciation and amortization of $9.4 million.

Our investing activities for 2002 consisted primarily of capital expenditures of $945,000, net purchases of marketable securities of $8.7 million offset by a reduction in restricted cash of $16.8 million, and a reduction in other assets of $3.1 million. Our investing activities for 2001 consisted primarily of capital expenditures of $12.6 million and restricted cash of $16.8 million, offset by net sales of marketable securities of $76.9 million and a reduction in other assets of $2.8 million. To support growth in headcount and global expansion, assets acquired in both 2002 and 2001 consisted principally of leasehold improvements, computer hardware and software. We expect that capital expenditures will total approximately $2.0 million over the next twelve months.

Effective December 24, 2002, we modified our existing working capital facility with Silicon Valley Bank (the Bank). Our eligible line of credit was increased to $20 million from $15 million. The new line is no longer tied to 80% of eligible accounts receivable. While there were no outstanding borrowings under the facility at December 31, 2002, we have issued letters of credit (LC s) totaling $13.9 million, which are supported by this facility. The line of credit bears interest at the Bank s prime rate (4.25% at December 31, 2002). As of December 31, 2002, approximately $6.1 million was available for future borrowings. The line of credit is secured by all of our tangible and intangible intellectual and personal property and is subject to financial covenants including liquidity coverage and profitability. The liquidity covenant mandates ATG maintain $40 million in cash at the end of each month throughout the duration of the facility. The profitability covenant allows for net losses not to exceed; $4.5 million for the fourth quarter of 2002, $4.0 million for the first quarter of 2003, $2.0 million for the second quarter of 2003, $1.0 million for the third and fourth quarters of 2003. The Bank has granted additional provisions, to be used if necessary, for a maximum $25 million in restructuring charges for the duration of the facility. Of the $25 million, a maximum of $7.5 million may be taken as a cash expense during the term of the facility; a second provision is made for a maximum of $12.0 million in cash to be paid toward real estate buy-outs. We are required to maintain $27 million in unrestricted cash with the Bank at all times, and in the event the balance should decrease, we will be required to pay fees and expenses to compensate the Bank for lost income. As of December 31, 2002, we were in compliance with all related financial covenants. In the event that we do not comply with any of the covenants within the line of credit or default on any of our provisions, the Bank s significant remedies include:

- Declaring all obligations immediately due and payable;
- Ceasing to advance money or extend credit for our benefit;
- Applying to the obligations any balances and deposits held by us or any amount held by the Bank owing to or for the credit or the account of us; and,
- Putting a hold on any deposit account held as collateral.

If the agreement expires, or is not extended, the Bank will require outstanding LC s at that time to be cash secured on terms acceptable to the Bank. The revolving line of credit expires on December 23, 2003.

As of December 31, 2002, we had commitments totaling approximately $13.9 million in the form of outstanding LC s in favor of our various landlords to secure obligations under our facility leases pursuant to leases expiring in 2003 through 2009. As of December 31, 2002, all of the LC s were secured under our line of credit.

Net cash provided by financing activities was $933,000 in 2002, principally representing proceeds from stock option exercises and the employee stock purchase plan, offset in part by payments on long-term obligations to BroadVision. Additionally, $1.1 million was received in the Tudor Settlement (related to the preferred stock litigation that was settled in May 2002). Net cash provided by financing activities was $706,000 in 2001, principally representing proceeds from stock option exercises and the employee stock purchase plan, offset in part by payments on long-term obligations to BroadVision.

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We lease our facilities under operating leases that expire between 2003 and 2011. The aggregate minimum annual rental payment under these leases is $92.6 million, which includes approximately $18.8 million payable in 2003. Of the $92.6 million, $70.7 million is included in the combined 2002 and 2001 restructuring charges. The $70.7 million was reduced to a $46.9 million restructuring charge after taking into consideration estimated sublease income and estimated vacancy periods. For additional information relating to our commercial and contractual commitments, see Notes 7 and 11 to our Consolidated Financial Statements contained in Item 8 of this Annual Report on Form 10-K.

Contractual Obligations

At December 31, 2002, our contractual cash obligations, which consist solely of operating leases, were as follows (in thousands):

	Payments Due by Period				
Contractual Obligations	**Total**	**Less Than 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 Years**
Lease Commitments	$92,627	$18,788	$31,573	$23,484	$18,782

We believe that our existing financial resources, together with cash generated by our operations, will be able to meet our cash requirements for at least the next twelve months. However, our actual cash requirements will depend on many factors, including particularly, overall economic conditions both domestically and abroad. We may seek additional external funds through public or private securities offerings, strategic alliances or other financing sources. There can be no assurance that if we seek external funding, it will be available on favorable terms, if at all.

Recent Accounting Pronouncements

In July 2002, the Financial Accounting Standards Board, or FASB, issued FAS 146, *Accounting for Costs Associated with Exit or Disposal Activities* (FAS 146), which addresses financial accounting and reporting for costs associated with exit or disposal activities. FAS 146 supercedes EITF 94-3 *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, and establishes when a liability for a cost associated with an exit or disposal activity must be recognized, which is at the time the liability is incurred. Severance pay, in many cases, would be recognized over time rather than up front. If the benefit arrangement requires employees to render future service beyond a minimum retention period a liability should be recognized as employees render service over the future service period even if the benefit formula used to calculate an employee s termination benefit is based on length of service. FAS 146 is effective for exit or disposal activities initiated after December 31, 2002, and is not expected to have a material impact on our consolidated financial statements.

On December 31, 2002, the FASB issued FAS 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (FAS 148). FAS 148 amends FAS 123, *Accounting for Stock-Based Compensation* (FAS 123), to provide alternative methods of transition to FAS 123 s fair value method of accounting for stock-based employee compensation in the event companies adopt FAS 123 and account for stock options under the fair value method. FAS 148 also amends the disclosure provisions of FAS 123 and APB Opinion No. 28, *Interim Financial Reporting* (APB 28), to require disclosure in the summary of significant accounting policies of the effects of an entity s accounting policy with respect to stock-based employee compensation on reported net income and earnings per share in annual and interim financial statements. While the Statement does not amend FAS 123 to require companies to account for employee stock options using the fair value method, the disclosure provisions of FAS 148 are applicable to all companies with stock-based employee compensation, regardless of whether they account for that compensation using the fair value method of FAS 123 or the intrinsic value method of APB Opinion No. 25 *Accounting for Stock Issued to Employees* (APB 25). As of December 31, 2002, we have adopted the disclosure requirements of FAS 148 as disclosed in the Notes to our Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

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In November 2002, the FASB issued Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45), which requires certain guarantees to be recorded at fair value as opposed to the current practice of recording a liability only when a loss is probable and reasonably estimable. FIN 45 also requires a guarantor to make significant new guaranty disclosures, even when the likelihood of making any payments under the guarantee is remote. The Interpretation s initial recognition and initial measurement provisions are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for interim or annual periods ending after December 15, 2002. We are not aware of any guarantees that require disclosure as of December 31, 2002.

In January 2003, the FASB issued Interpretation No. 46 *Consolidation of Variable Interest Entities* (FIN 46), which is an interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*. FIN 46 addresses consolidation by business enterprises of variable interest entities and requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved. Variable interest entities that effectively disperse risks will not be consolidated unless a single party holds an interest or combination of interests that effectively recombines risks that were previously dispersed. FIN 46 applies immediately to variable interest entities created after January 31, 2003 and to variable interest entities in which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. FIN 46 applies to public enterprises as of the beginning of the applicable interim or annual period. We do not expect that the adoption of FIN 46 will have a material effect on our financial position or results of operations.

Item 7a. ***Quantitative and Qualitative Disclosures About Market Risk***

We maintain an investment portfolio consisting mainly of investment grade money market funds, corporate obligations and government obligations with a weighted average maturity of less than one year. These held-to-maturity securities are subject to interest rate risk, however, a 10% change in interest rates would not have a material impact to the fair values of these securities primarily due to their short maturity and our intent to hold the securities to maturity. There have been no significant changes since December 31, 2002.

The majority of our operations are based in the U.S., and accordingly, the majority of our transactions are denominated in U.S. dollars. However, we have foreign-based operations where transactions are denominated in foreign currencies and are subject to market risk with respect to fluctuations in the relative value of currencies. Relative to foreign currency exposures existing at December 31, 2002, a 10% movement in foreign exchange rates would not expose us to significant gains or losses in earnings or cash flows. To date, foreign currency fluctuations have not had a material effect on our operating results. We may use derivative instruments to manage the risk of exchange rate fluctuations, however, at December 31, 2002, there were no outstanding derivative instruments. We do not use derivative instruments for trading or speculative purposes.

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

REPORT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

The Board of Directors and Stockholders

Art Technology Group, Inc.

We have audited the accompanying consolidated balance sheet of Art Technology Group, Inc. as of December 31, 2002 and the related consolidated statements of operations, stockholders equity and comprehensive income (loss) and cash flows for the year then ended. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Art Technology Group, Inc. as of December 31, 2001 and for each of the two years then ended were audited by other auditors who have ceased operations and whose report dated January 22, 2002 expressed an unqualified opinion on those statements before the reclassification adjustments and disclosures described in Note 1.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Art Technology Group, Inc. as of December 31, 2002 and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 1(p), effective January 1, 2002 the Company adopted Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*.

As discussed above, the consolidated financial statements of Art Technology Group, Inc. as of December 31, 2001 and for each of the two years then ended were audited by other auditors who have ceased operations. As described in Note 1(q), these consolidated financial statements have been revised to reflect restricted cash in the balance sheet at December 31, 2001 and the cash flow statement for the year ended December 31, 2001, and the statements of operations for the years ended December 31, 2001 and 2000 have been restated to conform to the 2002 presentation of including reimbursed expenses in revenue and cost of services revenue in accordance with Emerging Issues Task Force 01-14, *Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred*. We audited the adjustments that were applied to restate the balance sheet at December 31, 2001 and statement of cash flows for the year then ended and the statements of operations for the years ended December 31, 2001 and 2000. Our procedures included (a) agreeing the adjusted amounts for restricted cash, revenue and cost of services revenue to the Company s underlying records obtained from management, and (b) testing the mathematical accuracy in computing the restated consolidated financial statements. In our opinion, such adjustments are appropriate and have been properly applied. In addition, as described in Note 1(q), restricted cash has been disclosed as a separate line in Note 1(e) and in Note 9, accrued taxes have been disclosed as a separate line item comprising accrued expenses. We audited the adjustments that were applied to restate the disclosures reflected in Note 1(e) and Note 9 at December 31, 2001. Our procedures included (a) agreeing the adjusted amounts for restricted cash and accrued taxes to the Company s underlying records obtained from management, and (b) testing the mathematical accuracy in computing the restated disclosures contained in the notes to the consolidated financial statements. In our opinion, the disclosures in Note 1(e) and Note 9 for 2001 are appropriate. Further, as described in Note 1(q), these financial statements have been revised to include the transitional disclosures required by Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, which was adopted by the Company as of January 1, 2002. Our audit procedures with respect to the disclosures in Note 1(p) with respect to 2001 and 2000 included (a) agreeing the previously reported net loss

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in 2001 and net income in 2000 to the previously issued financial statements and the adjustments to reported net loss in 2001 and net income in 2000 representing amortization expense (including any tax effects) recognized in those periods related to goodwill to the Company s underlying records obtained from management, and (b) testing the mathematical accuracy of the reconciliation of adjusted net loss in 2001 and adjusted net income in 2000 to reported net loss in 2001 and reported net income in 2000, and the related earning (loss)-per-share amounts. In our opinion, the disclosures for 2001 and 2000 in Note 1(p) are appropriate. However, we were not engaged to audit, review, or apply any procedures to the 2001 and 2000 financial statements of the Company other than with respect to such adjustments and disclosures as described in Note 1 and, accordingly, we do not express an opinion or any other form of assurance on the 2001 and 2000 financial statements taken as a whole.

/s/ ERNST & YOUNG LLP

Boston, Massachusetts
January 20, 2003, except for Note 14, as
to which the date is March 24, 2003

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REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

THE FOLLOWING REPORT OF ARTHUR ANDERSEN LLP (ANDERSEN) IS A COPY OF THE REPORT PREVIOUSLY ISSUED BY ANDERSEN ON JANUARY 22, 2002. THE REPORT OF ANDERSEN IS INCLUDED IN THIS ANNUAL REPORT ON FORM 10-K PURSUANT TO RULE 2-02(E) OF REGULATION S-X. THE COMPANY HAS NOT BEEN ABLE TO OBTAIN A REISSUED REPORT FROM ANDERSEN. ANDERSEN HAS NOT CONSENTED TO THE INCLUSION OF ITS REPORT IN THIS ANNUAL REPORT ON FORM 10-K. BECAUSE ANDERSEN HAS NOT CONSENTED TO THE INCLUSION OF ITS REPORT IN THIS ANNUAL REPORT, IT MAY BE DIFFICULT TO SEEK REMEDIES AGAINST ANDERSEN AND THE ABILITY TO RECOVER ANY POTENTIAL DAMAGES AGAINST ANDERSEN MAY BE LIMITED.

To the Stockholders and Board of Directors of

Art Technology Group, Inc.:

We have audited the accompanying consolidated balance sheets of Art Technology Group, Inc. (a Delaware corporation) and subsidiaries as of December 31, 2000 and 2001, and the related consolidated statements of operations, stockholders equity (deficit) and comprehensive income (loss) and cash flows for each of the three years in the period ended December 31, 2001. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Art Technology Group, Inc. and subsidiaries as of December 31, 2000 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

/s/ ARTHUR ANDERSEN LLP

Boston, Massachusetts
January 22, 2002

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ART TECHNOLOGY GROUP, INC.

CONSOLIDATED BALANCE SHEETS

	December 31,	
	2002	**2001**
	(In thousands, except share and per-share information)	
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 45,829	$ 49,493
Marketable securities	22,729	14,057
Accounts receivable, net of reserves of $1,941 ($3,539 in 2001)	25,221	30,532
Unbilled services	5	274
Prepaid expenses and other current assets	2,484	5,541
Total current assets	96,268	99,897
Restricted Cash (Note 3)		16,757
Property and Equipment, Net	6,998	16,171
Other Assets	1,569	4,663
	$104,835	$137,488
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Current maturities of long-term obligations	$	$ 2,000
Accounts payable	2,563	4,160
Accrued expenses	18,219	24,718
Deferred revenue	15,674	17,628
Accrued restructuring, short-term	19,819	13,398
Total current liabilities	56,275	61,904
Accrued Restructuring, less current portion	32,537	32,675
Commitments and Contingencies (Note 3 and 7)		
Stockholders Equity:		
Preferred stock, $0.01 par value &nb		