

RTI INTERNATIONAL METALS INC

Form 10-Q

August 03, 2007

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

**FORM 10-Q**

(Mark One)

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

**FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2007**

OR

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

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

Commission file number: **001-14437**

**RTI INTERNATIONAL METALS, INC.**  
(Exact name of registrant as specified in its charter)

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

**52-2115953**  
(I.R.S. Employer  
Identification No.)

**1000 Warren Avenue, Niles, Ohio**  
(Address of principal executive offices)

**44446**  
(Zip Code)

**(330) 544-7700**  
Registrant's telephone number, including area code:

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

**Yes ☒ No ☐**

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check One):  
Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐

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

Number of shares of the Corporation's common stock ( Common Stock ) outstanding as of July 27, 2007 was 23,095,000.

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## RTI INTERNATIONAL METALS, INC. AND SUBSIDIARIES

As used in this report, the terms RTI, Company, Registrant, we, our, and us, mean RTI International Metals, predecessors, and consolidated subsidiaries, taken as a whole, unless the context indicates otherwise.

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Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements.****RTI INTERNATIONAL METALS, INC. AND SUBSIDIARIES****Condensed Consolidated Statements of Operations  
(Unaudited)****(In thousands, except share and per share amounts)**

|   | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|---|--|-------------|--------------------------------------|-------------|
|   | <b>2007</b>                            | <b>2006</b> | <b>2007</b>                          | <b>2006</b> |
| Net sales   | \$ 154,046                             | \$ 117,667  | \$ 299,603                           | \$ 232,746  |
| Cost and expenses:                                    |  |             |                                      |             |
| Cost of sales   | 106,720                                | 80,478      | 200,732                              | 161,330     |
| Selling, general, and administrative expenses         | 15,021                                 | 13,497      | 33,219                               | 30,132      |
| Research, technical, and product development expenses | 391                                    | 387         | 852                                  | 845         |
| Operating income                                      | 31,914                                 | 23,305      | 64,800                               | 40,439      |
| Other income (expense)                                | (364)                                  | 232         | (905)                                | 253         |
| Interest income                                       | 1,311                                  | 616         | 2,447                                | 1,125       |
| Interest expense                                      | (212)                                  | (103)       | (512)                                | (223)       |
| Income before income taxes                            | 32,649                                 | 24,050      | 65,830                               | 41,594      |
| Provision for income taxes                            | 11,699                                 | 8,923       | 22,807                               | 15,725      |
| Net income  | 20,950                                 | 15,127      | 43,023                               | 25,869      |
| Earnings per share:                                   |  |             |                                      |             |
| Basic   | \$ 0.91                                | \$ 0.67     | \$ 1.88                              | \$ 1.14     |
| Diluted   | \$ 0.90                                | \$ 0.66     | \$ 1.86                              | \$ 1.12     |
| Weighted-average shares outstanding:                  |  |             |                                      |             |
| Basic   | 22,924,717                             | 22,649,637  | 22,895,028                           | 22,602,552  |
| Diluted   | 23,177,641                             | 23,030,340  | 23,159,955                           | 23,015,942  |

*The accompanying notes are an integral part of these Consolidated Financial Statements.*



**Table of Contents****RTI INTERNATIONAL METALS, INC. AND SUBSIDIARIES****Condensed Consolidated Balance Sheets  
(Unaudited)****(In thousands, except share and per share amounts)**

|  | <b>June 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|--|--------------------------|------------------------------|
| <b><u>ASSETS</u></b>   |                          |                              |
| Current assets:  |                          |                              |
| Cash and cash equivalents  | \$ 27,249                | \$ 40,026                    |
| Investments  | 78,440                   | 85,035                       |
| Receivables, less allowance for doubtful accounts of \$689 and \$1,548 | 107,696                  | 92,517                       |
| Inventories, net   | 278,938                  | 241,638                      |
| Deferred income taxes  | 822                      | 2,120                        |
| Other current assets   | 7,024                    | 5,818                        |
| Total current assets   | 500,169                  | 467,154                      |
| Property, plant, and equipment, net                                    | 125,069                  | 102,470                      |
| Goodwill   | 49,716                   | 48,622                       |
| Other intangible assets, net   | 16,657                   | 15,581                       |
| Deferred income taxes  | 9,871                    | 9,076                        |
| Other noncurrent assets  | 988                      | 1,010                        |
| Total assets   | \$ 702,470               | \$ 643,913                   |
| <b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>                     |                          |                              |
| Current liabilities:   |                          |                              |
| Accounts payable   | \$ 41,925                | \$ 34,055                    |
| Accrued wages and other employee costs                                 | 14,382                   | 17,475                       |
| Billings in excess of costs and estimated earnings                     | 22,316                   | 21,147                       |
| Income taxes payable   |                          | 5,253                        |
| Deferred income taxes  |                          | 10,255                       |
| Current portion of long-term debt                                      | 504                      | 459                          |
| Current liability for post-retirement benefits                         | 2,783                    | 2,783                        |
| Current liability for pension benefits                                 | 580                      | 580                          |
| Other accrued liabilities  | 19,481                   | 9,436                        |
| Total current liabilities  | 101,971                  | 101,443                      |
| Long-term debt   | 16,323                   | 13,270                       |
| Non-current liability for post-retirement benefits                     | 32,951                   | 32,445                       |
| Non-current liability for pension benefits                             | 22,128                   | 22,285                       |
| Deferred income taxes  | 2,611                    | 5,422                        |

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|   |            |            |
|---|------------|------------|
| Other noncurrent liabilities  | 7,279      | 6,867      |
| Total liabilities   | 183,263    | 181,732    |
| Shareholders' equity:   |            |            |
| Common stock, \$0.01 par value; 50,000,000 shares authorized; 23,586,961 and 23,440,127 shares issued; 23,094,000 and 22,967,284 shares outstanding | 236        | 234        |
| Additional paid-in capital  | 298,930    | 289,448    |
| Treasury stock, at cost; 492,961 and 472,843 shares   | (6,859)    | (5,285)    |
| Accumulated other comprehensive loss  | (25,133)   | (31,226)   |
| Retained earnings   | 252,033    | 209,010    |
| Total shareholders' equity  | 519,207    | 462,181    |
| Total liabilities and shareholders' equity  | \$ 702,470 | \$ 643,913 |

*The accompanying notes are an integral part of these Consolidated Financial Statements.*



**Table of Contents****RTI INTERNATIONAL METALS, INC. AND SUBSIDIARIES****Condensed Consolidated Statements of Cash Flows  
(Unaudited)****(In thousands)**

|  | <b>Six Months Ended<br/>June 30,</b> |             |
|--|--------------------------------------|-------------|
|  | <b>2007</b>                          | <b>2006</b> |
| <b><u>OPERATING ACTIVITIES:</u></b>                        |                                      |             |
| Net income   | \$ 43,023                            | \$ 25,869   |
| Adjustment for non-cash items included in net income:      |                                      |             |
| Depreciation and amortization                              | 7,241                                | 7,134       |
| Deferred income taxes                                      | (13,165)                             |             |
| Stock-based compensation                                   | 4,306                                | 3,046       |
| Excess tax benefits from stock-based compensation activity | (3,477)                              | (2,918)     |
| Other  | (854)                                | 259         |
| Changes in assets and liabilities:                         |                                      |             |
| Receivables  | (12,748)                             | (9,910)     |
| Inventories  | (35,293)                             | (13,006)    |
| Accounts payable   | 9,336                                | 966         |
| Income taxes payable                                       | (3,524)                              | (204)       |
| Billings in excess of costs and estimated earnings         | 1,169                                | (3,331)     |
| Other current liabilities                                  | 11,583                               | 22          |
| Other assets and liabilities                               | (4,697)                              | 1,943       |
| Cash provided by operating activities                      | 2,900                                | 9,870       |
| <b><u>INVESTING ACTIVITIES:</u></b>                        |                                      |             |
| Proceeds from disposal of property, plant, and equipment   | 523                                  | 4           |
| Purchase of investments                                    | (840)                                |             |
| Proceeds from sale of investments                          | 7,435                                | 2,410       |
| Capital expenditures                                       | (27,045)                             | (9,224)     |
| Cash used by investing activities                          | (19,927)                             | (6,810)     |
| <b><u>FINANCING ACTIVITIES:</u></b>                        |                                      |             |
| Proceeds from exercise of employee stock options           | 1,526                                | 2,097       |
| Excess tax benefits from stock-based compensation activity | 3,477                                | 2,918       |
| Borrowings under credit agreements                         | 1,578                                |             |
| Purchase of common stock held in treasury                  | (1,574)                              | (882)       |
| Cash provided by financing activities                      | 5,007                                | 4,133       |

|  |           |           |
|--|-----------|-----------|
| Effect of exchange rate changes on cash and cash equivalents | (757)     | (6)       |
| Increase (decrease) in cash and cash equivalents             | (12,777)  | 7,187     |
| Cash and cash equivalents at beginning of period             | 40,026    | 53,353    |
| Cash and cash equivalents at end of period                   | \$ 27,249 | \$ 60,540 |

*The accompanying notes are an integral part of these Consolidated Financial Statements.*

Table of Contents**RTI INTERNATIONAL METALS, INC. AND SUBSIDIARIES****Condensed Consolidated Statement of Changes In Shareholders' Equity  
(Unaudited)****(In thousands, except share amounts)**

|   | <b>Shares of<br/>Common<br/>Stock<br/>Outstanding</b> | <b>Common<br/>Stock</b> | <b>Additional<br/>Paid in<br/>Capital</b> | <b>Treasury<br/>Stock</b> | <b>Retained<br/>Earnings</b> | <b>Accum.<br/>Other<br/>Comp<br/>Income/<br/>(Loss)</b> | <b>Total</b> | <b>Comprehensive<br/>Income</b> |
|---|---|-------------------------|---|---------------------------|------------------------------|---|--------------|---------------------------------|
| Balance at<br>December 31, 2006                           | 22,967,284  | \$ 234                  | \$ 289,448                                | \$ (5,285)                | \$ 209,010                   | \$ (31,226)   | \$ 462,181   |                                 |
| Shares issued for<br>directors' compensation              | 5,279   |                         |   |                           |                              |   |              |                                 |
| Shares issued for<br>restricted stock award<br>plans      | 53,946  | 1                       |   |                           |                              |   | 1            |                                 |
| Stock-based<br>compensation expense<br>recognized         |   |                         | 4,306                                     |                           |                              |   | 4,306        |                                 |
| Treasury stock<br>purchased at cost                       | (20,118)  |                         |   | (1,574)                   |                              |   | (1,574)      |                                 |
| Exercise of employee<br>options                           | 87,609  | 1                       | 1,525                                     |                           |                              |   | 1,526        |                                 |
| Tax benefits from<br>stock based<br>compensation activity |   |                         | 3,651                                     |                           |                              |   | 3,651        |                                 |
| Net income  |   |                         |   |                           | 43,023                       |   | 43,023       | \$ 43,023                       |
| Benefit plan<br>amortization                              |   |                         |   |                           |                              | 1,331   | 1,331        | 1,331                           |
| Foreign currency<br>translation                           |   |                         |   |                           |                              | 4,762   | 4,762        | 4,762                           |
| Comprehensive income                                      |   |                         |   |                           |                              |   |              | \$ 49,116                       |
| Balance at June 30,<br>2007                               | 23,094,000  | \$ 236                  | \$ 298,930                                | \$ (6,859)                | \$ 252,033                   | \$ (25,133)   | \$ 519,207   |                                 |

*The accompanying notes are an integral part of these Consolidated Financial Statements.*

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**RTI INTERNATIONAL METALS, INC. AND SUBSIDIARIES**

**Condensed Notes to Consolidated Financial Statements  
(Unaudited)**

**(In thousands, except share and per share amounts, unless otherwise indicated)**

**Note 1 BASIS OF PRESENTATION:**

The accompanying unaudited consolidated financial statements of RTI International Metals, Inc. and its subsidiaries (the Company or RTI) have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain information and note disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to those rules and regulations, although the Company believes that the disclosures made are adequate to make the information not misleading. In the opinion of management, these financial statements contain all of the adjustments of a normal and recurring nature considered necessary to state fairly the results for the interim periods presented. The results for the interim periods are not necessarily indicative of the results to be expected for the year.

The balance sheet at December 31, 2006 has been derived from the audited financial statements at that date, but does not include all of the information and notes required by accounting principles generally accepted in the United States for complete financial statements. Although the Company believes that the disclosures are adequate to make the information presented not misleading, it is suggested that these financial statements be read in conjunction with accounting policies and notes to consolidated financial statements included in the Company's 2006 Annual Report on Form 10-K.

**Note 2 ORGANIZATION:**

The Company is a leading U.S. producer of titanium mill products and fabricated metal components for the global market. RTI is a successor to entities that have been operating in the titanium industry since 1951. The Company first became publicly traded on the New York Stock Exchange in 1990 under the name RMI Titanium Co., and was reorganized into a holding company structure in 1998 under the symbol RTI. The Company conducts business in two segments: the Titanium Group and the Fabrication & Distribution Group (F&D Group). The Titanium Group melts and produces a complete range of titanium mill products, which are further processed by its customers for use in a variety of commercial aerospace, defense, and industrial applications. The titanium mill products consist of basic mill shapes including ingot, slab, bloom, billet, bar, plate, and sheet. The Titanium Group also produces ferro titanium alloys for steel-making customers and processes and distributes titanium powder. The F&D Group is comprised of companies that fabricate, machine, assemble, and distribute titanium and other specialty metal parts and components. Its products, many of which are engineered parts and assemblies, serve commercial aerospace, defense, oil and gas, power generation, and chemical process industries, as well as a number of other industrial and consumer markets.

**Table of Contents****RTI INTERNATIONAL METALS, INC. AND SUBSIDIARIES****Condensed Notes to Consolidated Financial Statements  
(Unaudited)****(In thousands, except share and per share amounts, unless otherwise indicated)****Note 3 STOCK-BASED COMPENSATION:*****Stock Options***

A summary of the status of the Company's stock options as of June 30, 2007, and the activity during the six months then ended, are presented below:

| <b>Stock Options</b>             | <b>Shares</b> |
|----------------------------------|---------------|
| Outstanding at December 31, 2006 | 403,194       |
| Granted                          | 62,700        |
| Forfeited                        | (3,235)       |
| Expired                          | (2,433)       |
| Exercised                        | (87,609)      |
| Outstanding at June 30, 2007     | 372,617       |
| Exercisable at June 30, 2007     | 234,436       |

The fair value of stock options granted was estimated at the date of grant using the Black-Scholes option-pricing model based upon the assumptions noted in the following table:

|                           | <b>2007</b> |
|---------------------------|-------------|
| Risk-free interest rate   | 4.84%       |
| Expected dividend yield   | 0.00%       |
| Expected lives (in years) | 5.0         |
| Expected volatility       | 42.00%      |

***Restricted Stock***

A summary of the status of the Company's nonvested restricted stock as of June 30, 2007, and the activity during the six months then ended, are presented below:

| <b>Nonvested Restricted Stock Awards</b> | <b>Shares</b> |
|--|---------------|
| Nonvested at December 31, 2006           | 166,254       |

|                            |          |
|----------------------------|----------|
| Granted                    | 59,225   |
| Vested                     | (74,353) |
| Nonvested at June 30, 2007 | 151,126  |

**Note 4 INCOME TAXES:**

Management evaluates the estimated annual effective income tax rate on a quarterly basis based on current and forecasted business levels and activities, including the mix of domestic and foreign results and enacted tax laws. To the extent that management determines that the Company's annual effective tax rate varies from the previous quarter's effective rate, the income tax provision will be adjusted in future quarters. Items unrelated to current year ordinary income are recognized entirely in the period identified as a discrete item of tax.

For the six months ended June 30, 2007, the estimated annual effective tax rate applied to ordinary income was 35.7%, compared to a rate of 37.5% for the six months ended June 30, 2006. The rate for 2007 differs from the federal statutory rate of 35% principally as a result of state taxes reduced by the benefit of the federal manufacturing deduction and tax exempt investment income. The rate for 2006 differs from the federal statutory rate of 35%

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**RTI INTERNATIONAL METALS, INC. AND SUBSIDIARIES**

**Condensed Notes to Consolidated Financial Statements  
(Unaudited)**

**(In thousands, except share and per share amounts, unless otherwise indicated)**

principally as a result of state and foreign taxes. The rate for 2007 is less than the comparable rate in 2006 because of an expected decrease in state taxes associated with the phase out of the Ohio income tax, an increase in the benefit derived from the federal manufacturing deduction, and tax exempt investment income.

Inclusive of discrete items, the Company recognized a provision for income taxes of \$11,699, or 35.8% of pretax income, and \$8,923, or 37.1% of pretax income for federal, state, and foreign income taxes for the three months ended June 30, 2007 and 2006, respectively. Discrete items recognized in both periods were immaterial.

Inclusive of discrete items, the Company recognized a provision for income taxes of \$22,807, or 34.6% of pretax income, and \$15,725, or 37.8% of pretax income for federal, state, and foreign income taxes for the six months ended June 30, 2007 and 2006, respectively. Discrete items reduced the provision for income taxes by \$695 for the six month period ended June 30, 2007, and related principally to prior year foreign tax credit benefits. Discrete items recognized during the six month period ended June 30, 2006 were immaterial.

Effective January 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board ( FASB ) Interpretation No. 48 ( FIN 48 ), *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement 109*. Based on the Company's analysis associated with the adoption of FIN 48, no cumulative effect adjustment was required. The total amount of unrecognized tax benefits as of January 1, 2007, was \$2,013. The total amount of unrecognized tax benefits as of June 30, 2007 was \$2,446. These increases reflect the impact of tax positions taken during 2007. All of these unrecognized tax benefits would affect the effective tax rate if recognized. During the six months ended June 30, 2007, there were no revisions to unrecognized tax benefits of prior periods, nor were there any settlements or reductions as a result in a lapse of the applicable statute of limitations.

The Company classifies interest and penalties as an element of tax expense. The amount of tax-related interest recognized in the Consolidated Statement of Operations for the six months ended June 30, 2007 and June 30, 2006, and the total tax-related interest expense accrued in the Consolidated Balance Sheets at December 31, 2006 and June 30, 2007, was not material. The Company does not believe it is exposed to penalties related to any material uncertain tax positions and thus none have been accrued in any period presented.

United States federal tax returns for tax years 2003 forward remain open to examination. The principal state jurisdictions that remain open to examination are Ohio, Pennsylvania, California, Missouri, and Texas, generally for the tax years 2003 forward. The principal foreign jurisdictions remaining open to examination, and the earliest open year, are the United Kingdom (2005), France (2003), and Canada (2004).

It is reasonably possible that the total amount of unrecognized tax benefits, which principally relate to the price of products and services between the U.S. companies and their foreign affiliates, will significantly change within the next twelve months. Approximately \$325 of unrecognized tax benefits may be recognized as a result of the expiration of the statute of limitations for tax year 2003. The remainder may be adjusted once additional data becomes available in the public domain that permits an update of the Company's most recently completed transfer pricing study. It is not possible to estimate a range of change that may result from the publication of this data. The limited additional data that became available during the second quarter did not change management's judgment concerning the amount of unrecognized tax benefits.





Table of Contents**RTI INTERNATIONAL METALS, INC. AND SUBSIDIARIES****Condensed Notes to Consolidated Financial Statements  
(Unaudited)****(In thousands, except share and per share amounts, unless otherwise indicated)****Note 5 EARNINGS PER SHARE:**

Earnings per share amounts for each period are presented in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 128, *Earnings Per Share*, which requires the presentation of basic and diluted earnings per share. Basic earnings per share was computed by dividing net income by the weighted-average number of shares of Common Stock outstanding for each respective period. Diluted earnings per share was calculated by dividing net income by the weighted-average of all potentially dilutive shares of Common Stock that were outstanding during the periods presented.

Actual weighted-average shares of Common Stock outstanding used in the calculation of basic and diluted earnings per share for the three and six months ended June 30, 2007 and 2006 were as follows:

|   | <b>Three Months Ended June 30,</b> |             | <b>Six Months Ended June 30,</b> |             |
|---|------------------------------------|-------------|----------------------------------|-------------|
|   | <b>2007</b>                        | <b>2006</b> | <b>2007</b>                      | <b>2006</b> |
| Numerator:                                  |                                    |             |                                  |             |
| Net income                                  | \$ 20,950                          | \$ 15,127   | \$ 43,023                        | \$ 25,869   |
| Denominator:                                |                                    |             |                                  |             |
| Basic weighted-average shares outstanding   | 22,924,717                         | 22,649,637  | 22,895,028                       | 22,602,552  |
| Effect of diluted securities                | 252,924                            | 380,703     | 264,927                          | 413,390     |
| Diluted weighted-average shares outstanding | 23,177,641                         | 23,030,340  | 23,159,955                       | 23,015,942  |
| Earnings per share:                         |                                    |             |                                  |             |
| Basic                                       | \$ 0.91                            | \$ 0.67     | \$ 1.88                          | \$ 1.14     |
| Diluted                                     | \$ 0.90                            | \$ 0.66     | \$ 1.86                          | \$ 1.12     |

For the three and six months ended June 30, 2007, options to purchase 62,325 and 52,100 shares of Common Stock, at an average price of \$77.90 and \$77.75 respectively, have been excluded from the calculation of diluted earnings per share because their effects were antidilutive. There were no options to purchase shares of Common Stock excluded from the calculation of earnings per share for the three and six months ended June 30, 2006.

**Note 6 INVENTORIES:**

Inventories are valued at cost as determined by the last-in, first-out ( LIFO ) method for approximately 58% and 57% of the Company's inventories at June 30, 2007 and December 31, 2006, respectively. The remaining inventories are valued at cost determined by a combination of the first-in, first-out ( FIFO ) and weighted-average cost methods. Inventory costs generally include materials, labor, and manufacturing overhead (including depreciation). When market conditions indicate an excess of carrying cost over market value, a lower-of-cost-or-market provision is recorded.

Inventories consisted of the following:

|                                    | <b>June 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|------------------------------------|--------------------------|------------------------------|
| Raw materials and supplies         | \$ 99,044                | \$ 70,662                    |
| Work-in-process and finished goods | 258,270                  | 210,629                      |
| LIFO reserve                       | (78,376)                 | (39,653)                     |
| Total inventories                  | \$ 278,938               | \$ 241,638                   |

Table of Contents**RTI INTERNATIONAL METALS, INC. AND SUBSIDIARIES****Condensed Notes to Consolidated Financial Statements  
(Unaudited)****(In thousands, except share and per share amounts, unless otherwise indicated)**

As of June 30, 2007 and December 31, 2006, the current cost of inventories exceeded their carrying value by \$78,376 and \$39,653, respectively. The Company's FIFO inventory value is used to approximate current costs.

**Note 7 GOODWILL AND OTHER INTANGIBLE ASSETS:**

Under SFAS No. 142, *Goodwill and Intangible Assets*, goodwill is subject to at least an annual assessment for impairment by applying a fair value based test. Absent any events throughout the year which would indicate potential impairment, the Company performs annual impairment testing during the fourth quarter. There have been no impairments to date. In the case of goodwill and long-lived assets, if future product demand or market conditions reduce management's expectation of future cash flows from these assets, a write-down of the carrying value of goodwill or long-lived assets may be required.

*Goodwill.* The carrying amount of goodwill attributable to each segment at December 31, 2006 and June 30, 2007 was as follows:

|                                  | <b>December 31,<br/>2006</b> | <b>Translation<br/>Adjustment/<br/>Other</b> | <b>June 30, 2007</b> |
|----------------------------------|------------------------------|--|----------------------|
| Titanium Group                   | \$ 2,591                     | \$ (43)                                      | \$ 2,548             |
| Fabrication & Distribution Group | 46,031                       | 1,137  | 47,168               |
| Total goodwill                   | \$ 48,622                    | \$ 1,094                                     | \$ 49,716            |

*Intangibles.* Intangible assets consist of customer relationships as a result of our acquisition of Claro Precision, Inc. (Claro) in 2004. These intangible assets, which were valued at fair value, are being amortized over 20 years. In the event that demand or market conditions change and the expected future cash flows associated with these assets is reduced, a write-down or acceleration of the amortization period may be required.

The carrying amount of intangible assets attributable to each segment at December 31, 2006 and June 30, 2007 was as follows:

|                | <b>December 31,<br/>2006</b> | <b>Amortization</b> | <b>Translation<br/>Adjustment</b> | <b>June 30,<br/>2007</b> |
|----------------|------------------------------|---------------------|-----------------------------------|--------------------------|
| Titanium Group | \$                           | \$                  | \$                                | \$                       |

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|                                  |           |          |          |           |
|----------------------------------|-----------|----------|----------|-----------|
| Fabrication & Distribution Group | 15,581    | (448)    | 1,524    | 16,657    |
| Total intangible assets          | \$ 15,581 | \$ (448) | \$ 1,524 | \$ 16,657 |

**Note 8 BILLINGS IN EXCESS OF COSTS AND ESTIMATED EARNINGS:**

The Company reported a liability for billings in excess of costs and estimated earnings of \$22,316 as of June 30, 2007 and \$21,147 as of December 31, 2006. These amounts primarily represent payments, received in advance from defense and energy market customers on long-term orders, which the Company has not recognized as revenues.

**Note 9 OTHER INCOME (EXPENSE):**

Other income (expense) for the three months ended June 30, 2007 and 2006 was \$(364) and \$232, respectively. Other income (expense) for the six months ended June 30, 2007 and 2006 was \$(905) and \$253, respectively. Other income (expense) consists primarily of foreign exchange gains and losses from international operations.

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(Unaudited)****(In thousands, except share and per share amounts, unless otherwise indicated)****Note 10 EMPLOYEE BENEFIT PLANS:**

Components of net periodic pension and other post-retirement benefit cost for the three and six months ended June 30, 2007 and 2006 for those salaried and hourly covered employees were as follows:

|   | <b>Pension Benefits</b>            |             |                                  |             | <b>Other Post-Retirement Benefits</b> |             |                                  |             |
|---|------------------------------------|-------------|----------------------------------|-------------|---------------------------------------|-------------|----------------------------------|-------------|
|   | <b>Three Months Ended June 30,</b> |             | <b>Six Months Ended June 30,</b> |             | <b>Three Months Ended June 30,</b>    |             | <b>Six Months Ended June 30,</b> |             |
|   | <b>2007</b>                        | <b>2006</b> | <b>2007</b>                      | <b>2006</b> | <b>2007</b>                           | <b>2006</b> | <b>2007</b>                      | <b>2006</b> |
| Service cost                                | \$ 503                             | \$ 509      | \$ 1,006                         | \$ 1,018    | \$ 121                                | \$ 112      | \$ 242                           | \$ 224      |
| Interest cost                               | 1,728                              | 1,619       | 3,456                            | 3,238       | 507                                   | 397         | 1,015                            | 795         |
| Expected return on plan assets              | (2,019)                            | (2,014)     | (4,038)                          | (4,029)     |                                       |             |                                  |             |
| Amortization of prior service cost          | 174                                | 208         | 347                              | 416         | 304                                   | 44          | 607                              | 88          |
| Amortization of unrealized gains and losses | 556                                | 621         | 1,113                            | 1,242       |                                       | 96          |                                  | 193         |
| Net periodic benefit cost                   | \$ 942                             | \$ 943      | \$ 1,884                         | \$ 1,885    | \$ 932                                | \$ 649      | \$ 1,864                         | \$ 1,300    |

**Note 11 COMMITMENTS AND CONTINGENCIES:**

From time to time, the Company is involved in litigation relating to claims arising out of its operations in the normal course of business. In our opinion, the ultimate liability, if any, resulting from these matters will have no significant impact on our Consolidated Financial Statements. Given the critical nature of many of the aerospace end uses for the Company's products, including specifically their use in critical rotating parts of gas turbine engines, the Company maintains aircraft products liability insurance of \$350 million, which includes grounding liability.

***Environmental Matters***

The Company is subject to environmental laws and regulations as well as various health and safety laws and regulations that are subject to frequent modifications and revisions. While the costs of compliance for these matters have not had a material adverse impact on the Company in the past, it is impossible to accurately predict the ultimate effect these changing laws and regulations may have on the Company in the future. The Company continues to evaluate its obligation for environmental-related costs on a quarterly basis and make adjustments in accordance with

provisions of Statement of Position 96-1, *Environmental Remediation Liabilities* and SFAS No. 5, *Accounting for Contingencies*.

Given the status of the proceedings at certain of these sites, and the evolving nature of environmental laws, regulations, and remediation techniques, the Company's ultimate obligation for investigative and remediation costs cannot be predicted. It is the Company's policy to recognize environmental costs in the financial statements when an obligation becomes probable and a reasonable estimate of exposure can be determined. When a single estimate cannot be reasonably made, but a range can be reasonably estimated, the Company accrues the amount it determines to be the most likely amount within that range.

Based on available information, RTI believes that its share of possible environmental-related costs is in a range from \$2,680 to \$6,999 in the aggregate. At June 30, 2007 and December 31, 2006, the amounts accrued for future environmental-related costs were \$3,624 and \$3,553, respectively. Of the total amount accrued at June 30, 2007,

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\$1,720 is expected to be paid out within one year and is included in the other accrued liabilities line of the balance sheet. The remaining \$1,904 is recorded in other noncurrent liabilities.

The Company has included \$531 and \$653 in its other current and noncurrent assets, respectively, for expected contributions from third parties. These third parties include prior owners of RTI property and prior customers of RTI that have agreed to partially reimburse the Company for certain environmental-related costs. The Company has been receiving contributions from such third parties for a number of years as partial reimbursement for costs incurred by the Company.

The following table summarizes the changes in the assets and liabilities for the six months ended June 30, 2007:

|  | <b>Environmental<br/>Assets</b> | <b>Environmental<br/>Liabilities</b> |
|--|---------------------------------|--------------------------------------|
| Balance at December 31, 2006           | \$ 1,252                        | \$ (3,553)                           |
| Environmental-related income (expense) | 319                             | (997)                                |
| Cash paid (received)                   | (387)                           | 926                                  |
| Balance at June 30, 2007               | \$ 1,184                        | \$ (3,624)                           |

As these proceedings continue toward final resolution, amounts in excess of those already provided may be necessary to discharge the Company from its obligations for these sites which include the Ashtabula River, the former Ashtabula Extrusion Plant, and the Reserve Environmental Services Landfill.

***Other Matters***

The Company maintained a program through a licensed broker acting as its authorized agent to recapture duty paid on imported titanium sponge as an offset against exports for products shipped outside the U.S. by the Company or its customers. The agent, who matched the Company's duty paid with the export shipments of its customers through filings with U.S. Customs and Border Protection ( U.S. Customs ), performed the recapture process.

The Company recognized a credit to Cost of Sales when it received notification from its agent that a claim had been filed and accepted by U.S. Customs.

During the second quarter of 2007, the Company received notice from U.S. Customs that the Company was under formal investigation for \$7.6 million of claims previously filed by the agent on our behalf. The investigation relates to discrepancies in, and lack of supporting documentation for claims filed through the Company's authorized agent. The Company has revoked the authorized agent's authority and intends to fully cooperate with U.S. Customs to determine to what extent any claims may be invalid or may not be supportable with adequate documentation. In response to the

investigation noted above, the Company has suspended the filing of new duty drawback claims while the investigation is performed.

Concurrent with the U.S Customs investigation, the Company is currently performing an internal review of historic claims filed with U.S. Customs to determine to what extent any claims may be invalid or may not have been supported with adequate documentation. In those instances, the Company is attempting to provide additional or supplemental documentation to U.S. Customs to support claims previously filed. As of the date of this filing, this review is not complete due to the extensive amount of documentation which must be examined, however, as a result of this review to date, the Company has recorded a charge of \$3.4 million to Cost of Sales. This charge was determined in accordance with SFAS No. 5, *Accounting for Contingencies*, and represents the Company's current best estimate of probable loss. Of this amount, \$2.7 million was recorded as a contingent current liability and \$0.7 million was recorded as a reserve against an outstanding receivable representing claims filed which had not yet



**Table of Contents****RTI INTERNATIONAL METALS, INC. AND SUBSIDIARIES****Condensed Notes to Consolidated Financial Statements  
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been paid by U.S. Customs. For the period January 1, 2001 through March 31, 2007, the Company had recognized a reduction of Cost of Sales totaling \$14.5 million associated with the recapture of duty paid. This amount represents the total of all claims filed by the agent on the Company's behalf. While the ultimate outcome of the U.S. Customs investigation and the Company's internal review is not yet known, based on current facts we believe there is an additional possible risk of loss between \$0 and \$11.1 million, exclusive of any amounts imposed for interest and penalties which cannot be quantified at this time.

The Company is also the subject of, or a party to, a number of other pending or threatened legal actions involving a variety of matters incidental to its business. The Company is of the opinion that the ultimate resolution of these matters will not have a significant impact on the results of the operations, cash flows or the financial position of the Company.

**Note 12 LONG-TERM DEBT:**

Long-term debt consists of:

|                              | <b>June 30, 2007</b> | <b>December 31,<br/>2006</b> |
|------------------------------|----------------------|------------------------------|
| RTI Claro credit agreement   | \$ 15,218            | \$ 13,729                    |
| Interest-free loan agreement | 1,609                |                              |
| Total debt                   | 16,827               | 13,729                       |
| Less: Current portion        | (504)                | (459)                        |
| Long-term debt               | \$ 16,323            | \$ 13,270                    |

As of June 30, 2007, the Company maintained an interest-free loan agreement which allows for borrowings of up to \$5,175 Canadian dollars. At June 30, 2007 exchange rates, this agreement allows for borrowings of up to \$4,866 U.S. dollars. This loan agreement was obtained through an affiliate of the Canadian government. Borrowings under this agreement are to be used for new equipment related to the capital expansion efforts at the Company's Montreal, Quebec facility. Under the terms of the loan, principal will be repaid in sixty equal, monthly and consecutive payments beginning twenty-four months following the first disbursement of the loan. The Company will begin repaying the loan in March 2009. During the six months ended June 30, 2007, the Company borrowed \$1,609 (U.S.) under this agreement. There were no borrowings outstanding under this agreement at December 31, 2006. The Company expects to utilize all availability associated with this credit facility by the end of 2008.

**Note 13 SEGMENT REPORTING:**

The Company's reportable segments are the Titanium Group and the F&D Group.

The Titanium Group manufactures and sells a wide range of titanium mill products to a customer base consisting primarily of manufacturing and fabrication companies in the commercial aerospace and nonaerospace markets. Titanium mill products are sold primarily to customers such as metal fabricators and forge shops in addition to the F&D Group. Titanium mill products are usually raw or starting material for these customers, who then form, fabricate, or further process mill products into finished or semi-finished components or parts.

The F&D Group is engaged primarily in the fabrication of titanium, specialty metals and steel products, including pipe and engineered tubular products, for use in the oil and gas and geo-thermal energy industries; hot and superplastically formed parts; and cut, forged, extruded, and rolled shapes for commercial aerospace and nonaerospace applications. This segment also provides warehousing, distribution, finishing, cut-to-size, and just-in-time delivery services of titanium, steel, and other metal products.

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Intersegment sales are accounted for at prices which are generally established by reference to similar transactions with unaffiliated customers. Reportable segments are measured based on segment operating income after an allocation of certain corporate items such as general corporate overhead and expenses. Assets of general corporate activities include unallocated cash and deferred taxes.

A summary of financial information by reportable segment is as follows:

|   | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|---|--|-------------|--------------------------------------|-------------|
|   | <b>2007</b>                            | <b>2006</b> | <b>2007</b>                          | <b>2006</b> |
| <b>Net sales:</b>   |  |             |                                      |             |
| Titanium Group  | \$ 62,690                              | \$ 51,437   | \$ 115,858                           | \$ 100,187  |
| Intersegment sales  | 44,001                                 | 33,717      | 94,000                               | 64,858      |
| Total Titanium Group net sales                                | 106,691                                | 85,154      | 209,858                              | 165,045     |
| Fabrication & Distribution Group                              | 91,356                                 | 66,230      | 183,745                              | 132,559     |
| Intersegment sales  | 1,573                                  | 1,524       | 3,785                                | 3,310       |
| Total Fabrication & Distribution Group net sales              | 92,929                                 | 67,754      | 187,530                              | 135,869     |
| Eliminations  | 45,574                                 | 35,241      | 97,785                               | 68,168      |
| Total consolidated net sales                                  | \$ 154,046                             | \$ 117,667  | \$ 299,603                           | \$ 232,746  |
| <b>Operating income:</b>                                      |  |             |                                      |             |
| Titanium Group before corporate allocations                   | \$ 24,161                              | \$ 18,661   | \$ 48,874                            | \$ 33,648   |
| Corporate allocations   | (2,502)                                | (1,650)     | (5,917)                              | (4,817)     |
| Total Titanium Group operating income                         | 21,659                                 | 17,011      | 42,957                               | 28,831      |
| Fabrication & Distribution Group before corporate allocations | 13,875                                 | 9,880       | 30,348                               | 20,376      |
| Corporate allocations   | (3,620)                                | (3,586)     | (8,505)                              | (8,768)     |
| Total Fabrication & Distribution Group operating income       | 10,255                                 | 6,294       | 21,843                               | 11,608      |
| Total consolidated operating income                           | \$ 31,914                              | \$ 23,305   | \$ 64,800                            | \$ 40,439   |
| <b>Income before income taxes:</b>                            |  |             |                                      |             |
| Titanium Group  | \$ 22,475                              | \$ 17,282   | \$ 44,468                            | \$ 29,426   |

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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Fabrication & Distribution Group              | 10,174    | 6,768     | 21,362    | 12,168    |
| Total consolidated income before income taxes | \$ 32,649 | \$ 24,050 | \$ 65,830 | \$ 41,594 |

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(Unaudited)****(In thousands, except share and per share amounts, unless otherwise indicated)**

|                                  | <b>June 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|----------------------------------|--------------------------|------------------------------|
| <b>Total assets:</b>             |                          |                              |
| Titanium Group                   | \$ 252,432               | \$ 228,305                   |
| Fabrication & Distribution Group | \$ 343,844               | 294,436                      |
| General corporate assets         | \$ 106,194               | 121,172                      |
| <br>Total consolidated assets    | <br>\$ 702,470           | <br>\$ 643,913               |

**Note 14 NEW ACCOUNTING STANDARDS:**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The provisions of SFAS 157 are effective for the fiscal year beginning January 1, 2008. The Company is currently evaluating the effect the adoption will have on its Consolidated Financial Statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115* ( SFAS 159 ). SFAS 159 permits entities to make an irrevocable election to measure certain financial instruments and other assets and liabilities at fair value on an instrument-by-instrument basis. Unrealized gains and losses on items for which the fair value option has been elected should be recognized into net earnings at each subsequent reporting date. SFAS 159 will become effective for the Company's fiscal year beginning January 1, 2008. The Company is currently evaluating the effect the adoption will have on its Consolidated Financial Statements.

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

**Forward-Looking Statements**

The following discussion should be read in connection with the information contained in the Consolidated Financial Statements and Condensed Notes to Consolidated Financial Statements. The following information contains

forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, and is subject to the safe harbor created by that Act. Such forward-looking statements may be identified by their use of words like expects, anticipates, intends, projects, or other words of similar meaning. Forward-looking statements are based on expectations and assumptions regarding future events. In addition to factors discussed throughout this quarterly report, the following factors and risks should also be considered, including, without limitation:

statements regarding the future availability and prices of raw materials,

competition in the titanium industry,

demand for the Company's products,

the historic cyclical nature of the titanium and commercial aerospace industries,

changes in defense spending,

the success of new market development,

long-term supply agreements,

waivers to and legislative challenges to the Specialty Metals Clause of the Berry Amendment,

global economic activities,

outcome of pending U.S. Customs investigation,

the successful completion of our expansion projects,

the Company's order backlog and the conversion of that backlog into revenue, and

other statements contained herein that are not historical facts.

Because such forward-looking statements involve risks and uncertainties, there are important factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements. These and other risk factors are set forth in this, as well as in other filings with the Securities and Exchange Commission (SEC) over the last 12 months, copies of which are available from the SEC or may be obtained upon request from the Company.

**Overview**

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RTI International Metals, Inc. (the Company, RTI, we, us, or our ) is a leading U.S. producer of titanium mill products and fabricated metal parts for the global market.

Net income for the three months ended June 30, 2007 totaled \$21.0 million, or \$0.90 per diluted share, on sales of \$154.0 million, compared with net income totaling \$15.1 million or \$0.66 per diluted share, on sales of \$117.7 million for the three months ended June 30, 2006. Net income for the six months ended June 30, 2007 totaled \$43.0 million, or \$1.86 per diluted share, on sales of \$299.6 million, compared with net income totaling \$25.9 million, or \$1.12 per diluted share, on sales of \$232.7 million for the six months ended June 30, 2006. Our increased sales and profitability, as compared to the same period in the prior year, was driven primarily by increased selling prices and continued strong demand from the commercial aerospace market for our titanium products across both of our operating segments.

We conduct our operations in two reportable segments: the Titanium Group and the Fabrication & Distribution Group ( F&D Group ). The Titanium Group melts and produces a complete range of titanium mill products which are further processed by its customers for use in a variety of commercial aerospace, defense, and industrial and

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consumer applications. The F&D Group is comprised of companies that fabricate, machine, assemble, and distribute titanium and other specialty metals parts and components. Its products, many of which are engineered parts and assemblies, serve commercial aerospace, defense, oil and gas, power generation, and chemical process industries, as well as a number of other industrial and consumer markets.

The Titanium Group, with operations in Niles, Ohio; Canton, Ohio; Salt Lake City, Utah; and Hermitage, Pennsylvania, has overall responsibility for the production of primary mill products including, but not limited to, bloom, billet, sheet, and plate. The Titanium Group also focuses on the research and development of evolving technologies relating to raw materials, melting, and other production processes, and the application of titanium to new markets. The F&D Group, with operations located throughout the U.S., Europe, and Canada, and representative offices in Germany, Italy, and China, concentrates its efforts on maximizing its profitability by offering value-added products and services such as engineered tubulars and extrusions, fabricated and machined components and sub-assemblies, as well as engineered systems for energy-related markets by accessing the Titanium Group as its primary source of mill products. For the three months ended June 30, 2007 and 2006, approximately 41% and 40%, respectively, of the Titanium Group's sales were to the F&D Group. For the six months ended June 30, 2007 and 2006, approximately 45% and 39%, respectively, of the Titanium Group's sales were to the F&D Group.

## **Duty Drawback Investigation**

We maintained a program through a licensed broker acting as our authorized agent to recapture duty paid on imported titanium sponge as an offset against exports for products shipped outside the U.S. by ourselves or our customers. The agent, who matched our duty paid with the export shipments of our customers through filings with U.S. Customs and Border Protection ( U.S. Customs ), performed the recapture process.

During the second quarter of 2007, we received notice from U.S. Customs that we are under formal investigation for \$7.6 million of claims previously filed by the agent on our behalf. The investigation relates to discrepancies in, and lack of supporting documentation for, claims filed through the authorized agent. We are fully engaged and cooperating with U.S. Customs in an effort to complete the investigation in an expedient manner.

We have revoked the authorized agent's authority and intend to fully cooperate with U.S. Customs to determine to what extent any claims may be invalid or may not be supportable with adequate documentation. In response to the investigation noted above, we have suspended the filing of new duty drawback claims while the investigation is performed.

Concurrent with the U.S. Customs investigation, we are currently conducting an internal review of our historic drawback claims filed with U.S. Customs to determine to what extent any claims may be invalid or may not have been supported with adequate documentation. In those instances, we are attempting to provide additional or supplemental documentation to U.S. Customs to support claims previously filed. As of the date of this filing, this review is not complete due to the extensive amount of documentation which must be examined, however, as a result of this review to date, we have recorded a charge of \$3.4 million to Cost of Sales. This charge was determined in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 5, *Accounting for Contingencies*, and represents our current best estimate of probable loss. Of this amount, \$2.7 million was recorded as a contingent current liability and \$0.7 million was recorded as a reserve against an outstanding receivable representing claims filed which had not yet been paid by U.S. Customs. For the period January 1, 2001 through March 31, 2007, we recognized a reduction of Cost of Sales totaling \$14.5 million associated with the recapture of duty paid. This amount represents the total of all claims filed by the agent on our behalf. While the ultimate outcome of the U.S. Customs investigation and our own internal review is not yet known, based on current facts we believe there is an additional possible risk of loss between \$0 and \$11.1 million, exclusive of any amounts imposed for interest and penalties which cannot be quantified at this time.





**Table of Contents****Three Months Ended June 30, 2007 Compared To Three Months Ended June 30, 2006**

*Net Sales.* Net sales for our reportable segments, excluding intersegment sales, for the three months ended June 30, 2007 and 2006 are summarized in the following table:

| <i>(In millions except percents)</i> | <b>Three Months<br/>Ended June 30,</b> |             | <b>\$</b>                       | <b>%</b>                        |
|--------------------------------------|--|-------------|---------------------------------|---------------------------------|
|                                      | <b>2007</b>                            | <b>2006</b> | <b>Increase/<br/>(Decrease)</b> | <b>Increase/<br/>(Decrease)</b> |
| Titanium Group                       | \$ 62.7                                | \$ 51.4     | \$ 11.3                         | 22.0%                           |
| Fabrication & Distribution Group     | 91.3                                   | 66.3        | 25.0                            | 37.7%                           |
| Total consolidated net sales         | \$ 154.0                               | \$ 117.7    | \$ 36.3                         | 30.8%                           |

Titanium Group's net sales increased due to an increase in average selling prices driven by continued strong demand from the commercial aerospace markets offset by a slight decrease in trade shipments of 50 thousand pounds as well as lower sales of non-prime products of \$5.7 million as compared to the same period in the prior year.

The increase in the F&D Group's net sales of \$25.0 million was primarily the result of continued strong demand from customers in most of the Group's businesses and product lines as well as increased selling prices. The additional demand led to increases of \$11.2 million from the segment's North American operations and an increase of \$13.8 million through European outlets.

*Gross Profit.* Gross profit for our reportable segments, for the three months ended June 30, 2007 and 2006 are summarized in the following table:

| <i>(In millions except percents)</i> | <b>Three Months<br/>Ended June 30,</b> |             | <b>\$</b>                       | <b>%</b>                        |
|--------------------------------------|--|-------------|---------------------------------|---------------------------------|
|                                      | <b>2007</b>                            | <b>2006</b> | <b>Increase/<br/>(Decrease)</b> | <b>Increase/<br/>(Decrease)</b> |
| Titanium Group                       | \$ 26.1                                | \$ 20.5     | \$ 5.6                          | 27.3%                           |
| Fabrication & Distribution Group     | 21.2                                   | 16.7        | 4.5                             | 26.9%                           |
| Total consolidated gross profit      | \$ 47.3                                | \$ 37.2     | \$ 10.1                         | 27.2%                           |

Excluding the \$3.4 million charge associated with the U.S. Customs investigation of our previously filed duty drawback claims, gross profit for the Titanium Group increased by \$9.0 million. This increase was primarily the result of higher average selling prices and increased volume from mill product shipments of \$11.0 million, offset by higher raw material costs and decreased profits on lower sales of non-prime products.

Gross profit for the F&D Group increased by \$4.5 million as a result of the increased sales from both the domestic and international operations.

*Selling, General, and Administrative Expenses.* Selling, general, and administrative expenses ( SG&A ) for our reportable segments, for the three months ended June 30, 2007 and 2006 are summarized in the following table:

| <i>(In millions except percents)</i> | <b>Three Months<br/>Ended June 30,</b> |             | <b>\$</b>                       | <b>%</b>                        |
|--------------------------------------|--|-------------|---------------------------------|---------------------------------|
|                                      | <b>2007</b>                            | <b>2006</b> | <b>Increase/<br/>(Decrease)</b> | <b>Increase/<br/>(Decrease)</b> |
| Titanium Group                       | \$ 4.1                                 | \$ 3.1      | \$ 1.0                          | 32.3%                           |
| Fabrication & Distribution Group     | 10.9                                   | 10.4        | 0.5                             | 4.8%                            |
| Total consolidated SG&A expenses     | \$ 15.0                                | \$ 13.5     | \$ 1.5                          | 11.1%                           |

Total SG&A expenses increased primarily due to an increase in compensation-related expense of \$1.7 million. Increases related to other administrative expenses were offset by a decrease in audit and accounting fees and bad debt expense as compared to the same period in the prior year.

*Research, Technical, and Product Development Expenses.* Research, technical, and product development expenses ( R&D ) was \$0.4 million for each of the three month periods ended June 30, 2007 and 2006.

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*Operating Income.* Operating income for our reportable segments, for the three months ended June 30, 2007 and 2006 is summarized in the following table:

| <i>(In millions except percents)</i> | <b>Three Months<br/>Ended June 30,</b> |             | <b>\$</b>                       | <b>%</b>                        |
|--------------------------------------|--|-------------|---------------------------------|---------------------------------|
|                                      | <b>2007</b>                            | <b>2006</b> | <b>Increase/<br/>(Decrease)</b> | <b>Increase/<br/>(Decrease)</b> |
| Titanium Group                       | \$ 21.6                                | \$ 17.0     | \$ 4.6                          | 27.1%                           |
| Fabrication & Distribution Group     | 10.3                                   | 6.3         | 4.0                             | 63.5%                           |
| Total operating income               | \$ 31.9                                | \$ 23.3     | \$ 8.6                          | 36.9%                           |

Excluding the \$3.4 million charge associated with the U.S. Customs investigation of our previously filed duty drawback claims, operating income for the Titanium Group increased by \$8.0 million. This increase was primarily the result of increased volume and average selling prices of mill products which was partially offset by increased SG&A costs compared to the same period in the prior year.

Operating income for the F&D Group increased by \$4.0 million primarily due to increased sales levels as a result of strong demand in both domestic and international operations compared to the same period in the prior year, which was partially offset by increased SG&A costs in the current year as compared to the same period in the prior year.

*Other Income (Expense).* Other income (expense) for the three months ended June 30, 2007 and 2006 was \$(0.4) million and \$0.2 million, respectively. Other income (expense) consists primarily of foreign exchange gains and losses from our international operations.

*Interest Income and Interest Expense.* Interest income for the three months ended June 30, 2007 and 2006 was \$1.3 million and \$0.6 million, respectively. The increase was due to an improvement in the effective rate of return for invested cash balances coupled with higher cash balances as compared to the same period in the prior year. Interest expense of \$0.2 million for the three months ended June 30, 2007 increased from \$0.1 million in the prior year due to higher debt levels in the current year.

*Provision for Income Taxes.* We recognized a provision for income taxes of \$11.7 million, or 35.8% of pretax income, and \$8.9 million, or 37.1% of pretax income for federal, state, and foreign income taxes for the three months ended June 30, 2007 and 2006, respectively. The annual effective tax rate applied to ordinary income decreased year over year as a result of lower estimated state taxes associated with the phase out of the Ohio income tax, an increased benefit from the federal manufacturing deduction, and tax exempt investment income. Items unrelated to current year ordinary income are recognized entirely in the period identified. Discrete items recognized in the three months ended June 30, 2007 and 2006 were immaterial.

**Six Months Ended June 30, 2007 Compared To Six Months Ended June 30, 2006**

*Net Sales.* Net sales for our reportable segments, excluding intersegment sales, for the six months ended June 30, 2007 and 2006 are summarized in the following table:

**Six Months  
Ended June 30,**

| <i>(In millions except percents)</i> | <b>2007</b> | <b>2006</b> | <b>\$<br/>Increase/<br/>(Decrease)</b> | <b>%<br/>Increase/<br/>(Decrease)</b> |
|--------------------------------------|-------------|-------------|--|---------------------------------------|
| Titanium Group                       | \$ 115.9    | \$ 100.2    | \$ 15.7                                | 15.7%                                 |
| Fabrication & Distribution Group     | 183.7       | 132.5       | 51.2                                   | 38.6%                                 |
| Total consolidated net sales         | \$ 299.6    | \$ 232.7    | \$ 66.9                                | 28.7%                                 |

Titanium Group's net sales increased due to an increase in average selling prices driven by continued strong demand from the commercial aerospace markets offset by a slight decrease in trade shipments of 450 thousand pounds as well as lower sales of non-prime products of \$10.2 million as compared to the same period in the prior year.

The increase in the F&D Group's net sales of \$51.2 million was primarily the result of continued strong demand from customers in most of the Group's businesses and product lines as well as increased selling prices. The

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additional demand led to increases of \$23.3 million from the segment's North American operations and an increase of \$27.9 million through European outlets.

*Gross Profit.* Gross profit for our reportable segments, for the six months ended June 30, 2007 and 2006 are summarized in the following table:

|                                      | Six Months             |         | \$                      | %                       |
|--------------------------------------|------------------------|---------|-------------------------|-------------------------|
|                                      | Ended June 30,<br>2007 | 2006    | Increase/<br>(Decrease) | Increase/<br>(Decrease) |
| <i>(In millions except percents)</i> |                        |         |                         |                         |
| Titanium Group                       | \$ 52.8                | \$ 37.6 | \$ 15.2                 | 40.4%                   |
| Fabrication & Distribution Group     | 46.1                   | 33.8    | 12.3                    | 36.4%                   |
| Total consolidated gross profit      | \$ 98.9                | \$ 71.4 | \$ 27.5                 | 38.5%                   |

Excluding the \$3.4 million charge associated with the U.S. Customs investigation of our previously filed duty drawback claims, gross profit for the Titanium Group increased by \$18.6 million. This increase was primarily the result of higher average selling prices and increased volume from mill product shipments of \$21.2 million, offset by higher raw material costs and decreased profits on lower sales of non-prime products.

Gross profit for the F&D Group increased by \$12.3 million as a result of the increased sales from both the domestic and international operations.

*Selling, General, and Administrative Expenses.* Selling, general, and administrative expenses ( SG&A ) for our reportable segments, for the six months ended June 30, 2007 and 2006 are summarized in the following table:

|                                      | Six Months             |         | \$                      | %                       |
|--------------------------------------|------------------------|---------|-------------------------|-------------------------|
|                                      | Ended June 30,<br>2007 | 2006    | Increase/<br>(Decrease) | Increase/<br>(Decrease) |
| <i>(In millions except percents)</i> |                        |         |                         |                         |
| Titanium Group                       | \$ 9.1                 | \$ 8.0  | \$ 1.1                  | 13.8%                   |
| Fabrication & Distribution Group     | 24.1                   | 22.1    | 2.0                     | 9.0%                    |
| Total consolidated SG&A expenses     | \$ 33.2                | \$ 30.1 | \$ 3.1                  | 10.3%                   |

Total SG&A expenses increased by \$3.1 million primarily due to an increase in compensation-related expense. Increases related to other administrative expenses were substantially offset by a decrease in audit and accounting fees and bad debt expense as compared to the same period in the prior year.

*Research, Technical, and Product Development Expenses.* Research, technical, and product development expenses ( R&D ) for the six months ended June 30, 2007 and 2006 were \$0.9 million and \$0.8 million, respectively.

*Operating Income.* Operating income for our reportable segments, for the six months ended June 30, 2007 and 2006 is summarized in the following table:

| <i>(In millions except percents)</i> | <b>Six Months<br/>Ended June 30,</b> |             | <b>\$</b>                       | <b>%</b>                        |
|--------------------------------------|--------------------------------------|-------------|---------------------------------|---------------------------------|
|                                      | <b>2007</b>                          | <b>2006</b> | <b>Increase/<br/>(Decrease)</b> | <b>Increase/<br/>(Decrease)</b> |
| Titanium Group                       | \$ 43.0                              | \$ 28.8     | \$ 14.2                         | 49.3%                           |
| Fabrication & Distribution Group     | 21.8                                 | 11.6        | 10.2                            | 87.9%                           |
| Total operating income               | \$ 64.8                              | \$ 40.4     | \$ 24.4                         | 60.4%                           |

Excluding the \$3.4 million charge associated with the U.S. Customs investigation of our previously filed duty drawback claims, operating income for the Titanium Group increased by \$17.6 million. This increase was primarily the result of increased volume and average selling prices of mill products which was partially offset by increased SG&A costs compared to the same period in the prior year.

Operating income for the F&D Group increased by \$10.2 million primarily due to increased sales levels as a result of strong demand in both domestic and international operations compared to the same period in the prior year which was partially offset by increased SG&A costs in the current year as compared to the same period in the prior year.

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*Other Income (Expense).* Other income (expense) for the six months ended June 30, 2007 and 2006 was \$(0.9) million and \$0.3 million, respectively. Other income (expense) consists primarily of foreign exchange gains and losses from our international operations.

*Interest Income and Interest Expense.* Interest income for the six months ended June 30, 2007 and 2006 was \$2.4 million and \$1.1 million, respectively. The increase was due to an improvement in the effective rate of return for invested cash balances coupled with higher cash balances as compared to the same period in the prior year. Interest expense of \$0.5 million for the six months ended June 30, 2007 increased from \$0.2 million in the prior year due to higher debt levels in the current year.

*Provision for Income Taxes.* We recognized a provision for income taxes of \$22.8 million, or 34.6% of pretax income, and \$15.7 million, or 37.8% of pretax income for federal, state, and foreign income taxes for the six months ended June 30, 2007 and 2006, respectively. The annual effective tax rate applied to ordinary income decreased year over year as a result of lower estimated state taxes associated with the phase out of the Ohio income tax, an increased benefit from the federal manufacturing deduction, and tax exempt investment income. Items unrelated to current year ordinary income are recognized entirely in the period identified. During the six months ended June 30, 2007, approximately \$0.7 million was recognized as a discrete adjustment reducing tax expense relating principally to prior year foreign tax credit benefits. Discrete items recognized in the six months ended June 30, 2006 were immaterial.

**Outlook**

On May 30, 2007, we entered into an amendment to our existing contract with Lockheed Martin Aeronautics Company on behalf of Lockheed Martin Corporation ( Lockheed Martin ) for the long-term supply of titanium products in support of the F-35 Joint Strike Fighter Program (the JSF Program ). Under the agreement, as amended, we will supply the first eight million pounds of titanium mill products (including sheet, plate, and billet) required by the JSF program per year through the end of 2020, with actual volumes to be based on JSF Program build rates and ultimate titanium content per aircraft variant. In addition to the first eight million pounds per year, Lockheed Martin has a one-time right of refusal to procure up to an additional 1.1 million pounds of titanium plate annually in the event volumes become available from any ramp-down in the F-22 Raptor program. To support this contract amendment, we have begun a \$100 million facilities expansion program.

On February 13, 2007, we entered into a new contract for the long-term supply of titanium sponge with a Japanese supplier. This agreement runs through 2016 and will provide the Company with supply of up to 13 million pounds annually, beginning in 2009. We have agreed to purchase a minimum of 10 million pounds annually for the first five years thereafter. During the latter years of the contract, quantities can be reduced by the election of various options by both parties. Prices will be negotiated annually.

As of June 30, 2007, we were a party to several multi-year agreements supporting the production of new Boeing and Airbus aircraft. Multiple facilities will support the production of the finished titanium components under these contracts. These long-term contracts represent major steps forward in our strategy to supply more value-added products and services.

In connection with the long-term commercial contracts related to the new Boeing and Airbus aircraft, two expansion projects, totaling approximately \$78 million, are ongoing at various facilities. The first project, totaling approximately \$35 million, consists of additions to the Company's melting and forging capabilities primarily at our Canton and Niles, Ohio facilities. This project will enhance both flexibility and raw capacity in our mill product operations in support of our expanded supply relationship with Airbus, as well as other growing market demand. The project is expected to be completed during the third quarter of 2007, with the exception of one furnace that will be completed during the first quarter of 2008.



The second project, totaling approximately \$43 million, will support the Company's growing value-added opportunities, including the contracts to supply machined components to Kawasaki Heavy Industries and Fuji Heavy Industries for their portion of the Boeing 787 program. Investments will include expanded conditioning capabilities in our extrusion operations and additional machining capacity at our Houston, Texas and Montreal, Quebec facilities. The project is expected to be completed during the third quarter of 2007.

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*Backlog.* Our order backlog for all markets decreased to approximately \$541 million as of June 30, 2007, as compared to \$606 million at December 31, 2006. Of the backlog at June 30, 2007, approximately \$349 million is likely to be realized over the remainder of 2007. We define backlog as firm business scheduled for release into our production process for a specific delivery date. We have numerous requirement contracts that extend multiple years for a variety of programs that are not included in backlog until a specific release into production or a firm delivery date has been established.

## **Liquidity and Capital Resources**

We believe that the use of our current cash reserves and expected positive cash flows from operations as well as existing borrowing capacity (see Credit Agreement later in this section) provides adequate liquidity taking into consideration our recently announced capital projects related to new business awards. We currently have low levels of debt and based on the expected strength of future cash flows, we do not believe there are any significant near term risks related to fluctuations in interest rates.

*Cash provided by operating activities.* Cash provided by operating activities for the six months ended June 30, 2007 and 2006, was \$2.9 million and \$9.9 million, respectively. The decrease in net cash flows from operating activities for the six months ended June 30, 2007 compared to the six months ended June 30, 2006 primarily reflects increased levels of working capital, primarily driven by accounts receivable and inventory, partially offset by an increase in profitability.

*Cash used by investing activities.* Cash used by investing activities, for the six months June 30, 2007 and 2006, was \$19.9 million and \$6.8 million, respectively. The increase in the amount of cash used by investing activities was primarily due to increased spending on capital projects related to new contracts previously discussed in the Outlook section.

*Cash provided by financing activities.* Cash provided by financing activities, for the six months ended June 30, 2007 and 2006, was \$5.0 million and \$4.1 million, respectively. The increase in cash provided by financing activities for the six months ended June 30, 2007, compared to the six months ended June 30, 2006, primarily reflects borrowings under our interest free loan agreement.

## **Credit Agreement**

As of June 30, 2007, we maintained an interest-free loan agreement which allows for borrowings of up to \$5.2 million Canadian dollars. At June 30, 2007 exchange rates, this agreement allows for borrowings of up to \$4.9 million U.S. dollars. This loan agreement was obtained through an affiliate of the Canadian government. Borrowings under this agreement are to be used for new equipment related to the capital expansion efforts at our Montreal, Quebec facility. Under the terms of the loan, principal will be repaid in sixty equal, monthly and consecutive payments beginning in March 2009. At June 30, 2007, we had borrowings totaling \$1.6 million (U.S.) under this agreement. We anticipate utilizing all availability associated with this credit facility by the end of 2008.

## **Environmental Matters**

We are subject to environmental laws and regulations as well as various health and safety laws and regulations that are subject to frequent modifications and revisions. While the costs of compliance for these matters have not had a material adverse impact on the Company in the past, it is impossible to predict accurately the ultimate effect these changing laws and regulations may have on the Company in the future. We continue to evaluate our obligation for environmental related costs on a quarterly basis and make adjustments in accordance with provisions of Statement of Position 96-1, *Environmental Remediation Liabilities* and SFAS No. 5, *Accounting for Contingencies*.

Given the status of the proceedings at certain of these sites, and the evolving nature of environmental laws, regulations, and remediation techniques, our ultimate obligation for investigative and remediation costs cannot be predicted. It is our policy to recognize environmental costs in the financial statements when an obligation becomes probable and a reasonable estimate of exposure can be determined. When a single estimate cannot be reasonably made, but a range can be reasonably estimated, we accrue the amount we determine to be the most likely amount within that range.

Based on available information, we believe that our share of possible environmental-related costs is in a range from \$2.7 million to \$7.0 million in the aggregate. At both June 30, 2007 and December 31, 2006, the amount accrued for future environmental-related costs was \$3.6 million. Of the total amount accrued, approximately

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\$1.7 million is expected to be paid out within one year and is included in other accrued liabilities line on the balance sheet. The remaining \$1.9 million is recorded in other noncurrent liabilities.

We have included \$0.5 million and \$0.7 million in other current and noncurrent assets, respectively, for expected contributions from third parties. These third parties include prior owners of RTI property and prior customers of RTI, that have agreed to partially reimburse us for certain environmental-related costs. We have been receiving contributions from such third parties for a number of years as partial reimbursement for costs incurred by the Company.

As these proceedings continue toward final resolution, amounts in excess of those already provided may be necessary to discharge us from our obligations for these sites, which include the Ashtabula River, the former Ashtabula Extrusion Plant, and the Reserve Environmental Services Landfill.

## **New Accounting Standards**

In July 2006, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 48 ( FIN 48 ), *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement 109*. FIN 48 prescribes a comprehensive model on how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that it has taken or expects to take on a tax return. FIN 48 became effective as of January 1, 2007. Based on our analysis performed in association with the adoption of FIN 48, no cumulative effect adjustment was required.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements* ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The provisions of SFAS 157 are effective for our fiscal year beginning January 1, 2008. We are currently evaluating the effect the adoption will have on our Consolidated Financial Statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115* ( SFAS 159 ). SFAS 159 permits entities to make an irrevocable election to measure certain financial instruments and other assets and liabilities at fair value on an instrument-by-instrument basis. Unrealized gains and losses on items for which the fair value option has been elected should be recognized into net earnings at each subsequent reporting date. SFAS 159 will become effective for our fiscal year beginning January 1, 2008. We are currently evaluating the effect the adoption will have on our Consolidated Financial Statements.

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

There have been no significant changes in our exposure to market risk from the information provided in Item 7A. Quantitative Disclosures About Market Risk on our Form 10-K filed with the SEC on February 28, 2007.

## **Item 4. Controls and Procedures.**

As of June 30, 2007, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)). Based on that evaluation, the Company's management concluded that the Company's disclosure controls and procedures were effective as of June 30, 2007.

During the three months ended June 30, 2007, the Company implemented a new financial reporting and consolidation software package, Hyperion Enterprise, designed to provide additional financial reporting functionality and to improve overall control and efficiency associated with the financial reporting process. During the implementation, we designed internal controls within the system to ensure the new process is operating effectively. Other than this software installation, there were no changes in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended June 30, 2007 that materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings.**

As discussed in Note 11 Commitments and Contingencies, of the Condensed Notes to Consolidated Financial Statements, and in Part I, Item 2 under the caption Duty Drawback Investigation, each of which is incorporated herein by reference, we received notice from U.S. Customs during the second quarter of 2007 that we are under formal investigation for \$7.6 million of duty drawback claims previously filed on our behalf by a licensed broker acting as our authorized agent. We have revoked the authorized agent's authority and intend to fully cooperate with U.S. Customs to determine to what extent any claims may be invalid or may not be supportable with adequate documentation.

Concurrent with the U.S. Customs investigation, we are currently conducting an internal review of our historic drawback claims filed with U.S. Customs to determine to what extent any claims may be invalid or may not have been supported with adequate documentation. As detailed in Note 11, we have recorded a charge of \$3.4 million to Cost of Sales. This charge was determined in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 5, *Accounting for Contingencies*, and represents our current best estimate of probable loss. While the ultimate outcome of the U.S. Customs investigation and our own internal review is not yet known, based on current facts we believe there is an additional possible risk of loss between \$0 and \$11.1 million, exclusive of any amounts imposed for interest and penalties which may be assessed but cannot be quantified at this time.

**Item 1A. Risk Factors.**

The Company has evaluated its risk factors and determined that, other than those set forth below, there have been no material changes to the Company's risk factors set forth in Part I, Item 1A, in the Form 10-K since the Company filed its Annual Report on Form 10-K, on February 28, 2007 except for the additional risk factor identified below.

**The outcome of the U.S. Customs investigation of our previously filed duty drawback claims.**

The Company has received notice from U.S. Customs indicating that certain duty drawback claims previously filed by the Company's agent, on behalf of the Company, are under formal investigation. The investigation relates to discrepancies in, and lack of supporting documentation for, claims filed through the Company's authorized agent. The ultimate outcome of the U.S. Customs investigation cannot be determined, however, the outcome of this investigation could have an adverse impact on our financial performance.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

While the Company repurchases shares of Common Stock from time to time, it did not repurchase any shares of Common Stock during the three and six months ended June 30, 2007 or 2006 under the RTI International Metals, Inc. share repurchase program. The share repurchase program was approved by the Company's Board of Directors on April 30, 1999, and authorizes the repurchase of up to \$15 million of RTI Common Stock. At June 30, 2007, approximately \$12 million of the \$15 million remained available for repurchase. There is no expiration date specified for the share repurchase program.

In addition to the share repurchase program, employees may surrender shares to the Company to pay tax liabilities associated with the vesting of restricted stock awards under the 2004 stock plan. There were no shares surrendered during the three months ended June 30, 2007.



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

The annual meeting of shareholders was held on April 27, 2007. In connection with the meeting, proxies were solicited pursuant to the Securities Exchange Act of 1934. The following are the voting results on proposals considered and voted upon at the meeting, all of which were described in the Company's proxy statement for such meeting.

All nominees for directors listed in the proxy statement were elected. Listed below are the names of each director elected, together with their individual vote totals.

| <b>Nominee</b>         | <b>For</b> | <b>Withheld</b> |
|------------------------|------------|-----------------|
| Craig R. Andersson     | 20,515,673 | 2,031,116       |
| Daniel I. Booker       | 20,515,460 | 2,031,329       |
| Donald P. Fusilli, Jr. | 20,835,549 | 1,711,240       |
| Ronald L. Gallatin     | 20,516,323 | 2,030,466       |
| Charles C. Gedeon      | 20,516,493 | 2,030,296       |
| Robert M. Hernandez    | 20,514,870 | 2,031,919       |
| Dawne S. Hickton       | 20,532,629 | 2,014,160       |
| Edith E. Holiday       | 20,817,217 | 1,729,572       |
| Michael C. Wellham     | 20,541,665 | 2,005,124       |
| James A. Williams      | 20,834,979 | 1,711,810       |

The appointment of PricewaterhouseCoopers LLP as the Company's independent registered public accounting firm for 2007 was ratified.

|   | <b>For</b> | <b>Against</b> | <b>Abstain</b> |
|---|------------|----------------|----------------|
| Ratification of independent registered public accounting firm | 22,444,858 | 22,583         | 79,349         |

**Item 6. Exhibits.**

The exhibits listed on the Index to Exhibits are filed herewith and incorporated herein by reference.



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**SIGNATURES**

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

RTI INTERNATIONAL METALS, INC.

Dated: August 3, 2007

By /s/ William T. Hull  
William T. Hull  
*Senior Vice President and Chief Financial Officer*

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**Table of Contents****INDEX TO EXHIBITS**

| <b>Exhibit<br/>No.</b> | <b>Description</b>  |
|------------------------|---|
| 10.1                   | Amendment to Long-Term Supply Agreement, dated May 30, 2007, between the Company and Lockheed Martin Corporation and its affiliates, filed herewith.  |
| 31.1                   | Certification of Chief Executive Officer required by Item 307 of Regulation S-K as promulgated by the Securities and Exchange Commission and pursuant to Section 302 of Sarbanes-Oxley Act of 2002, filed herewith.     |
| 31.2                   | Certification of Principal Financial Officer required by Item 307 of Regulation S-K as promulgated by the Securities and Exchange Commission and pursuant to Section 302 of Sarbanes-Oxley Act of 2002, filed herewith. |
| 32.1                   | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.  |
| 32.2                   | Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.  |

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|       |        |
|-------|--------|
| )     | (4     |
|       | 9,152  |
| Total |        |
| \$    | 12,161 |
| \$    | 3      |
| \$    | (5     |
| )     |        |
| \$    | 12,159 |

As of March 31, 2008 and September 30, 2007, all marketable securities had maturity dates less than one year. For the three and six months ended March 31, 2008, less than \$0.1 million of gains were realized on the sale of marketable securities. For the three and six months ended March 31, 2007, no gains or losses were realized on the sale of marketable securities. Subsequent to March 31, 2008, all marketable securities were sold and converted to cash equivalents.



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

## NOTE 5—RESTRUCTURING

## Restructuring Costs

Through March 31, 2008, the Company approved certain restructuring plans to, among other things, reduce its workforce and consolidate facilities. Restructuring and asset impairment expenses have been recorded to align the Company's cost structure with changing market conditions and to create a more efficient organization. The Company's restructuring expenses have been comprised primarily of: (i) severance and termination benefit costs related to reductions in our workforce; and (ii) lease termination costs and costs associated with permanently vacating certain facilities. The Company accounted for each of these costs in accordance with SFAS No. 146 or SFAS 146, "Accounting for Costs Associated with Exit or Disposal Activities" or previous guidance under Emerging Issues Task Force 94-3 or EITF 94-3.

Retroactive application of SFAS 146 to periods prior to January 1, 2003, was prohibited; accordingly, the accrual relating to facilities vacated prior to the effective date of SFAS 146 continues to be accounted for in accordance with the guidance of EITF 94-3. Accruals for facilities that were restructured prior to 2003 do not reflect any adjustments relating to the estimated net present value of cash flows associated with the facilities.

For each of the periods presented herein, restructuring expenses consist solely of:

• **Severance and Termination Benefits**—These costs represent severance and payroll taxes related to restructuring plans.

• **Excess Facilities**—These costs represent future minimum lease payments related to excess and abandoned office space under leases, the disposal of property and equipment including facility leasehold improvements, net of estimated sublease income.

As of March 31, 2008, the total restructuring accrual consisted of the following (in thousands):

|                           | Current | Non-Current | Total    |
|---------------------------|---------|-------------|----------|
| Severance and termination | \$ 135  | \$ —        | \$ 135   |
| Excess facilities         | 419     | 733         | 1,152    |
| Total                     | \$ 554  | \$ 733      | \$ 1,287 |

As of March 31, 2008 and September 30, 2007, \$0.6 million and \$3.0 million, respectively, of the restructuring reserve is included in the Accrued Expenses line item on the Condensed Consolidated Balance Sheets. The allocation between current portion and long term portion is based on the current lease agreements.

The Company expects the remaining severance and termination benefit accrual will be substantially paid by September 30, 2008.

The Company expects to pay the excess facilities amounts related to the restructured or vacated leased office space as follows (in thousands):

Fiscal Year Ended September 30,

|                             | Total<br>Future<br>Minimum<br>Lease<br>Payments |
|-----------------------------|---|
| 2008 (remaining six months) | \$ 211  |
| 2009                        | 412   |
| 2010                        | 404   |
| 2011                        | 125   |
| Total                       | \$ 1,152  |

Included in the future minimum lease payments schedule above is an offset of \$0.8 million of contractually committed sublease rental income.

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

## Fiscal Year 2007 Restructuring

In October 2006, the Company initiated a restructuring plan intended to align its resources and cost structure with expected future revenues. The restructuring plan included a balancing of service resources worldwide, elimination of duplicative functions internationally, and a shift in the U.S. field organization toward a focus on domain-based sales and pre-sales teams. As a result of the restructuring plan, management undertook a reduction of 33 positions or approximately 10% of the Company's workforce and consolidation of the European headquarters in the United Kingdom and the closure of the France office or 2007 Restructuring.

As part of the fiscal year 2007 Restructuring, the Company initially incurred a one-time restructuring expense of \$6.5 million for severance and termination benefits, and excess facilities expensed to Restructuring Expense in the Condensed Consolidated Statements of Operations. The Company accrued lease costs pertaining to the consolidation of excess facilities relating to lease terminations and non-cancelable lease costs in France and the United Kingdom. During the three months ended March 31, 2007, the Company incurred an additional charge of \$0.1 million for employee severance costs associated with the closure of the France office. In March 2007, the Company negotiated an early termination of the France office lease associated with its closure resulting in a \$0.2 million reduction in the restructure facility liability. This reduction was recorded as an offset to restructuring expense in the period. The Company was able to terminate the France facility lease during the year ended September 30, 2007. In the quarter ended December 31, 2007, the Company negotiated an early termination option for the United Kingdom lease which terminated the lease in January 2008. All termination payments have now been made.

The following table summarizes the activity related to the 2007 Restructuring (in thousands):

|  | Excess<br>Facilities |
|--|----------------------|
| Reserve balance as of September 30, 2007 | \$ 2,526             |
| Charge/adjustment                        | (36)                 |
| Non-cash                                 | (62)                 |
| Cash paid                                | (2,428)              |
| Reserve balance as of March 31, 2008     | \$ —                 |

## Fiscal Year 2005 Restructuring

In May 2005, the Company appointed a task force to improve profitability and control expenses. The goal of the task force was to create a better alignment of functions within the Company, to make full utilization of the Company's India development center, to develop a closer relationship between the Company's field operations and customers, to review the sales and implementation models, as well adjust the organization model to flatten management levels, to review the Company's product line, and to enhance the Company's business model for profitability and operating leverage. This work resulted in an approximate 10% reduction in the Company's workforce, or 2005 Restructuring, and in July 2005 affected employees were notified. As part of the 2005 Restructuring, the Company incurred a one-time restructuring charge of \$1.1 million in the fourth quarter ended September 30, 2005 for severance and termination benefits.

During the six months ended March 31, 2007, the Company incurred an additional charge of less than \$0.1 million for additional severance expense for an employee located in France.

The following table summarizes the activity related to the 2005 Restructuring (in thousands):

|  | Severance<br>and<br>Termination<br>Benefits |
|--|---|
| Reserve balance as of September 30, 2007 | \$ 100                                      |
| Charge/adjustment                        | 38  |
| Non-cash                                 | (3)   |
| Cash paid                                | —   |
| Reserve balance as of March 31, 2008     | \$ 135                                      |

#### Prior Restructurings

During fiscal year 2002, based upon the Company's continued evaluation of economic conditions in the information technology industry and our expectations regarding revenue levels, the Company restructured several areas so as to reduce

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expenses and improve revenue per employee, or 2002 Restructuring. As part of the 2002 Restructuring, the Company recorded a total workforce reduction expense relating to severance and termination benefits of approximately \$2.0 million and \$3.8 million for years ended December 31, 2003 and 2002, respectively. In addition to these costs, the Company accrued lease costs related to excess facilities of \$0.2 million and \$2.8 million during the years ended December 31, 2003 and 2002, respectively, pertaining to the consolidation of excess facilities relating to lease terminations and non-cancelable lease costs. This expense was net of estimated sublease income based on current comparable rates for leases in the respective markets.

During the year ended September 30, 2007, the Company entered into a new sublease for the last remaining facility lease associated with the 2002 Restructuring. As a result of this sublease rental income being lower than previously estimated as part of the restructure facility reserve, the Company recorded an additional \$0.3 million of restructuring expense during the year ended September 30, 2007. The sublease term is through the entire remaining term of the Company's lease obligation for the facility.

The following table summarizes the activity related to the 2002 Restructuring (in thousands):

|  | Excess<br>Facilities |
|--|----------------------|
| Reserve balance as of September 30, 2007 | \$ 1,360             |
| Non-cash                                 | —                    |
| Cash paid                                | (208)                |
| Reserve balance as of March 31, 2008     | \$ 1,152             |

## NOTE 6—COMPREHENSIVE INCOME (LOSS)

The components of comprehensive income (loss) are as follows (in thousands):

|  | Three Months Ended March 31, |          | Six Months Ended March 31, |            |
|--|------------------------------|----------|----------------------------|------------|
|  | 2008                         | 2007     | 2008                       | 2007       |
| Net income (loss)                              | \$ (1,159)                   | \$ 4,975 | \$ (954)                   | \$ (5,774) |
| Other comprehensive income (loss):             |                              |          |                            |            |
| Foreign currency translation gain              | 685                          | 79       | 713                        | 531        |
| Net change in unrealized gain from investments | (9)                          | —        | (4)                        | —          |
| Comprehensive income (loss)                    | \$ (483)                     | \$ 5,054 | \$ (245)                   | \$ (5,243) |

## NOTE 7—RELATED PARTY TRANSACTIONS

Charles E. Hoffman, a director of the Company, is the President and Chief Executive Officer of Covad Communications Group, Inc., or Covad, a customer of ours. Pursuant to software and services agreements, revenue from Covad was approximately \$0.1 million for the three and six months ended March 31, 2008 and 2007, respectively. Accounts receivable from Covad was nil and \$0.3 million as of March 31, 2008 and September 30, 2007, respectively. Deferred revenue from Covad was nil and \$0.1 million as of March 31, 2008 and September 30, 2007,



respectively.

## NOTE 8—BORROWINGS

### Revolving line of credit

The Company's revolving line of credit with Comerica Bank was amended and restated on March 8, 2006, subsequently amended and extended to March 7, 2008 and extended three additional months to June 7, 2008. The terms of the agreement include a \$5.0 million line of credit, available on a non-formula basis, and requires the Company to maintain (i) at least a \$5.0 million cash balance in Comerica Bank accounts, (ii) a minimum quick ratio of 2 to 1, (iii) a liquidity ratio of at least 1 to 1 at all times, and (iv) subordinate any debt issuances subsequent to the effective date of the agreement, and certain other covenants. All assets of the Company have been pledged as collateral on the credit facility.

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The revolving line of credit contains a provision for a sub-limit of up to \$5.0 million for issuances of standby commercial letters of credit. As of March 31, 2008, the Company had utilized \$0.2 million of the standby commercial letters of credit limit of which \$0.2 million serves as collateral for computer equipment leases for Ness (see Note 9). The revolving line of credit also contains a provision for a sub-limit of up to \$3.0 million for issuances of foreign exchange forward contracts. As of March 31, 2008, the Company had not entered into any foreign exchange forward contracts. Pursuant to the amendment in March 2006, the Company is required to secure the standby commercial letters of credit and foreign exchange forward contracts through June 7, 2008. If these have not been secured to Comerica Bank's satisfaction, the Company's cash and cash equivalent balances held by Comerica Bank automatically secure such obligations to the extent of the then continuing or outstanding and undrawn letters of credit or foreign exchange contracts.

Borrowings under the revolving line of credit bear interest at the lending bank's prime rate. Except for the standby commercial letters of credit, as of March 31, 2008, there were no outstanding balances on the revolving line of credit.

## NOTE 9—COMMITMENTS AND CONTINGENCIES

## Lease Commitments

The Company leases its facilities and certain equipment under non-cancelable operating leases that expire on various dates through 2013. Rent expense is recognized on a straight line basis over the lease term.

Future minimum lease payments as of March 31, 2008 are as follows (in thousands):

|                                 | Operating<br>Leases | Operating<br>Sublease<br>Income | Net<br>Operating<br>Leases |
|---------------------------------|---------------------|---------------------------------|----------------------------|
| Fiscal year ended September 30: |                     |                                 |                            |
| 2008 (remaining six months)     | \$ 1,610            | \$ (139)                        | \$ 1,471                   |
| 2009                            | 2,586               | (283)                           | 2,303                      |
| 2010                            | 2,377               | (293)                           | 2,084                      |
| 2011                            | 1,781               | (86)                            | 1,695                      |
| 2012                            | 916                 | —                               | 916                        |
| Thereafter                      | 660                 | —                               | 660                        |
| Total minimum payments          | \$ 9,930            | \$ (801)                        | \$ 9,129                   |

Operating lease obligations in the table above include approximately \$1.9 million for our Boston, Massachusetts facility operating lease commitment that is included in Restructuring Expense. As of March 31, 2008, the Company has \$0.8 million in sublease income contractually committed for future periods relating to this facility. See Note 5 for further discussion.

The office lease for our Cupertino headquarters expires on December 31, 2008. In April 2008, the Company has exercised an option to renew our lease for an additional five years at ninety-five percent of the fair market value on December 31, 2008. While market rates can not be determined at this time, the Company expects our operating lease expense for this facility to increase effective January 1, 2009.

## Asset Retirement Obligations

As required by SFAS No.143 “Accounting for Asset Retirement Obligations”, or SFAS 143, and Interpretation No. 47, “Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143”, or FIN 47, the Company recorded an Asset Retirement Obligation (ARO) of approximately \$0.3 million and a corresponding increase in leasehold improvements in the fiscal year 2007. SFAS 143 and FIN 47 requires the recognition of a liability for the fair value of a legally required conditional asset retirement obligation when incurred, if the liability’s fair value can be reasonably estimated. The fair value of the liability is added to the carrying amount of the associated asset and this additional carrying amount is amortized over the life of the asset.

The Company’s asset retirement obligations are associated with commitments to return property subject to operating leases to original condition upon lease termination. As of March 31, 2008, the Company estimated that gross expected cash flows of approximately \$0.4 million will be required to fulfill these obligations.

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Asset retirement obligation payments as of March 31, 2008 are included in Other Long-term Liabilities and are estimated as follows (in thousands):

|                                 | Payments |
|---------------------------------|----------|
| Fiscal year ended September 30: |          |
| 2008 (remaining six months)     | \$ —     |
| 2009                            | —        |
| 2010                            | —        |
| 2011                            | 159      |
| 2012                            | 206      |
| Total                           | \$ 365   |

### Other Obligations

The Company entered into an agreement with Ness Technologies Inc., Ness USA, Inc. (formerly Ness Global Services, Inc.) and Ness Technologies India, Ltd. (collectively, “Ness”), effective December 15, 2003, pursuant to which Ness provides the Company’s customers with technical product support through a worldwide help desk facility, a sustaining engineering function that serves as the interface between technical product support and internal engineering organization, product testing services and product development services (collectively, the “Services”). The agreement had an initial term of three years and was extended for two additional one year terms. Under the terms of the agreement, the Company pays for services rendered on a monthly fee basis, including the requirement to reimburse Ness for approved out-of-pocket expenses. The agreement may be terminated for convenience by the Company, subject to the payment of a termination fee. In 2004, 2005, 2006 and 2007 the Company further expanded its agreement with Ness whereby Ness is providing certain additional technical and consulting services. The additional agreements can be cancelled at the option of the Company without the payment of a termination fee. The remaining minimum purchase commitment under these agreements, if Chordiant was to cancel the contracts, was approximately \$0.7 million at March 31, 2008. In addition to service agreements, the Company has also guaranteed certain equipment lease obligations of Ness (see Note 8). Ness may procure equipment to be used in performance of the Services, either through leasing arrangements or direct cash purchases, for which the Company is obligated under the agreement to reimburse them. In connection with the procurement of equipment, Ness has entered into a 36 month equipment lease agreement with IBM India and, in connection with the lease agreement the Company has an outstanding standby letter of credit in the amount of \$0.2 million in guarantee of Ness’ financial commitments under the lease. Over the term of the lease, the Company’s obligation to reimburse Ness is approximately equal to the amount of the guarantee.

### Indemnification

As permitted under Delaware law, the Company has agreements whereby the Company has indemnified our officers, directors and certain employees for certain events or occurrences while the employee, officer or director is, or was serving, at the Company’s request in such capacity. The term of the indemnification period is for the officer’s or director’s lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a Director and Officer insurance policy that limits the Company’s exposure and may enable the Company to recover a portion of any future amounts paid. Future payments may be required to defend current and former directors in the derivative class action lawsuit described in Note 10. As a result of insurance policy coverage, the Company believes the estimated fair value of these

indemnification agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of March 31, 2008.

The Company enters into standard indemnification agreements in our ordinary course of business. Pursuant to these agreements, the Company agrees to indemnify, defend, hold harmless, and to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally the Company's business partners or customers, in connection with any patent, copyright or other intellectual property infringement claim by any third party with respect to the Company's products. The term of these indemnification agreements is generally perpetual after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. The Company has not incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. The Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of March 31, 2008.

The Company enters into arrangements with our business partners, whereby the business partners agree to provide services as subcontractors for the Company's implementations. The Company may, at its discretion and in the ordinary course of business, subcontract the performance of any of these services. Accordingly, the Company enters into standard indemnification

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agreements with its customers, whereby the Company indemnifies them for other acts, such as personal property damage by its subcontractors. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has general and umbrella insurance policies that may enable the Company to recover a portion of any amounts paid. The Company has not incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of March 31, 2008.

When, as part of an acquisition, the Company acquires all of the stock or all of the assets and liabilities of a company, the Company may assume the liability for certain events or occurrences that took place prior to the date of acquisition. The maximum potential amount of future payments, if any, the Company could be required to make for such obligations is undeterminable at this time. Accordingly, the Company has no amounts recorded for these contingent liabilities as of March 31, 2008.

The Company warrants that software products will perform in all material respects in accordance with standard published specifications and documentation in effect at the time of delivery of the licensed products to the customer for a specified period of time. Additionally, the Company warrants that maintenance and consulting services will be performed consistent with generally accepted industry standards. If necessary, the Company would provide for the estimated cost of product and service warranties based on specific warranty claims and claim history, however, the Company has not incurred significant expense under product or services warranties to date. As a result, the Company believes the estimated fair value on these warranties is minimal. Accordingly, the Company has no amounts recorded for these contingent liabilities as of March 31, 2008.

NOTE 10—LITIGATION

IPO Laddering

Beginning in July 2001, the Company and certain of its officers and directors, or Individuals, were named as defendants in a series of class action stockholder complaints filed in the United States District Court for the Southern District of New York, now consolidated under the caption, “In re Chordiant Software, Inc. Initial Public Offering Securities Litigation, Case No. 01-CV-6222”. In the amended complaint, filed in April 2002, the plaintiffs allege that the Company, the Individuals, and the underwriters of the Company’s initial public offering, or IPO, violated section 11 of the Securities Act of 1933 and section 10(b) of the Exchange Act of 1934 based on allegations that the Company’s registration statement and prospectus failed to disclose material facts regarding the compensation to be received by, and the stock allocation practices of, the Company’s IPO underwriters. The complaint also contains claims against the Individuals for control person liability under Securities Act section 15 and Exchange Act section 20. The plaintiffs seek unspecified monetary damages and other relief. Similar complaints were filed in the same court against hundreds of other public companies, or Issuers, that conducted IPO’s of their common stock in the late 1990’s or in the year 2000 (collectively, the “IPO Lawsuits”).

In August 2001, all of the IPO Lawsuits were consolidated for pretrial purposes before United States Judge Shira Scheindlin of the Southern District of New York. In July 2002, the Company joined in a global motion to dismiss the IPO Lawsuits filed by all of the Issuers (among others). In October 2002, the Court entered an order dismissing the Individuals from the IPO Lawsuits without prejudice, pursuant to an agreement tolling the statute of limitations with respect to the Individuals. In February 2003, the court issued a decision denying the motion to dismiss against

Chordiant and many of the other Issuers.

In June 2003, Issuers and plaintiffs reached a tentative settlement agreement that would, among other things, result in the dismissal with prejudice of all claims against the Issuers and Individuals in the IPO Lawsuits, and the assignment to plaintiffs of certain potential claims that the Issuers may have against the underwriters. The tentative settlement also provides that, in the event that plaintiffs ultimately recover less than a guaranteed sum of \$1 billion from the IPO underwriters, plaintiffs would be entitled to payment by each participating Issuer's insurer of a pro rata share of any shortfall in the plaintiffs' guaranteed recovery. In September 2003, in connection with the possible settlement, those Individuals who had entered tolling agreements with plaintiffs (described above) agreed to extend those agreements so that they would not expire prior to any settlement being finalized. In June 2004, Chordiant and almost all of the other Issuers entered into a formal settlement agreement with the plaintiffs. On February 15, 2005, the Court issued a decision certifying a class action for settlement purposes, and granting preliminary approval of the settlement subject to modification of certain bar orders contemplated by the settlement. On August 31, 2005, the Court reaffirmed class certification and preliminary approval of the modified settlement in a comprehensive Order, and directed that Notice of the settlement be published and mailed to class members beginning November 15, 2005. On February 24, 2006, the Court dismissed litigation filed against certain underwriters in connection with the claims to be assigned to the plaintiffs under the settlement. On April 24, 2006, the Court held a Final Fairness Hearing to determine whether to grant final approval of the settlement. On December 5, 2006, the Second Circuit Court of Appeals vacated the lower Court's earlier decision certifying as class actions the six IPO Lawsuits designated as "focus cases." Thereafter, the District Court ordered a stay of all proceedings in all of the IPO Cases pending the outcome of plaintiffs' petition to the Second Circuit for rehearing en banc. On April 6, 2007, the Second Circuit

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denied plaintiffs' rehearing petition, but clarified that the plaintiffs may seek to certify a more limited class in the district court. Accordingly, the settlement will not be finally approved. Plaintiffs filed amended complaints in six "focus cases" on or about August 14, 2007. The Company is not a focus case. In September 2007, the Company's named officers and directors again extended the tolling agreement with plaintiffs. On or about September 27, 2007, plaintiffs moved to certify the classes alleged in the focus cases and to appoint class representatives and class counsel in those cases. The focus case issuers filed motions to dismiss the claims against them on or about November 9, 2007 and an opposition to plaintiffs' motion for class certification on December 21, 2007. On March 16, 2008, the court denied the motions to dismiss in the focus cases. This action may divert the efforts and attention of our management and, if determined adversely to us, could have a material impact on our business, results of operations, financial condition or cash flows.

Derivative Class Action

On August 1, 2006, a stockholder derivative complaint was filed in the United States District Court for the Northern District of California by Jesse Brown under the caption Brown v. Kelly, et al. Case No. C06-04671 JW (N.D. Cal.). On September 13, 2006, a second stockholder derivative complaint was filed in the United States District Court for the Northern District of California by Louis Suba under the caption Suba v. Kelly et al., Case No. C06-05603 JW (N.D. Cal.). Both complaints were brought purportedly on behalf of the Company against certain current and former officers and directors. On November 27, 2006, the court entered an order consolidating these actions and requiring the plaintiffs to file a consolidated complaint. The consolidated complaint was filed on January 11, 2007. The consolidated complaint alleges, among other things, that the named officers and directors: (a) breached their fiduciary duties as they colluded with each other to backdate stock options, (b) violated section 10(b), 14(a) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder through their alleged actions, and (c) were unjustly enriched by their receipt and retention of such stock options. On May 21, 2007, the Company filed a motion to dismiss the entire action on the grounds that the plaintiffs failed to take the steps necessary to bring a derivative action. Instead of opposing the motion to dismiss on November 14, 2007, the plaintiffs filed an Amended Complaint adding new allegations against five more current and former officer and directors. The substantive allegations in the Amended Complaint are similar to those in the previous complaint. On December 14, 2007, the Company again filed a motion to dismiss the entire action on the grounds that the plaintiffs failed to take the steps necessary to bring a derivative action. The individual defendants also filed a motion to dismiss. On January 22, 2008, the parties reached a tentative non-binding agreement in principle on the settlement of this lawsuit. The parties are working to finalize and memorialize the terms of that settlement and will then seek court approval of the settlement. Under the tentative proposal the Company's cash contribution toward the settlement would not be material to the financial statements.

Patent Claim

In September 2006, the Company received a letter from Acacia Technologies Group, a patent holding company, suggesting that the Company may be infringing on two patents, designated by United States Patent Numbers 5,537,590 and 5,701,400, which are held by one of their patent licensing and enforcement subsidiaries. The Company is currently reviewing the validity of these patents and whether the Company's products may infringe upon them. The Company has not formed a view of whether the Company may have liability for infringement of these patents. Any related claims, whether or not they have merit, could be costly and time-consuming to defend, divert management's attention or cause product delays. If any of the Company's products were found to infringe such patents, the patent holder could seek an injunction to enjoin use of the infringing product. If the Company was required to settle such a claim, it could have a material impact on our business, results of operations, financial condition or cash flows.



Yue vs Chordiant Software, Inc.

On January 2, 2008, the Company and certain of our officers and one other employee were named in a complaint filed in the United States District Court for the Northern District of California by Dongxiao Yue under the caption Dongxiao Yue v. Chordiant Software, Inc. et al. Case No. CV 08-0019 BZ (N.D. Cal.). The complaint alleges that the Company's Marketing Director software product infringed copyrights in certain software referred to as the "PowerRPC software," copyrights which had been owned by Netbula LLC and assigned to Mr. Yue, the sole employee and owner of Netbula. The alleged infringement includes (a) distributing more copies of the PowerRPC software than had originally been authorized in a run time license Netbula granted to Chordiant Software, Intl., (b) infringement of a software developer kit ("SDK") by making copies of the SDK in excess of those that had been licensed by Netbula, (c) making unauthorized derivative works of the SDK, (d) unauthorized distribution of PowerRPC for products operating on the Windows Vista platform, (e) unauthorized distribution of PowerRPC for server based products. Plaintiff also claims that the license Netbula granted to Chordiant Software, Int'l Ltd. should not be construed to authorize uses by its parent company, Chordiant Software, Inc. The plaintiff seeks monetary damages, disgorgement of profits, and injunctive relief according to proof. The Company and its officers and employees have filed a motion to dismiss the complaint for failure to state a claim upon which relief could be granted, and as to lack of personal jurisdiction as to one employee. These motions are presently scheduled for hearing in June 2008.

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The Company, from time to time, is also subject to various other claims and legal actions arising in the ordinary course of business. The ultimate disposition of these various other claims and legal actions is not expected to have a material effect on our business, financial condition, results of operations or cash flows. However, litigation is subject to inherent uncertainties.

NOTE 11—INCOME TAXES

Effective October 1, 2007, the Company adopted FIN No. 48 “Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109”. FIN 48 prescribes a recognition threshold and measurement guidance for the financial statement reporting of uncertain tax positions taken or expected to be taken in a company’s income tax return. FIN 48 also provides guidance related to recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition matters related to uncertain tax positions. FIN 48 utilizes a two-step approach for evaluating uncertain tax positions accounted for in accordance with SFAS 109. Step one, recognition, requires a company to determine if the weight of available evidence indicates that a tax position is more likely than not to be sustained upon audit, including the resolution of related appeals or litigation processes, if any. Step two, measurement, is based on the largest amount of benefit, which is more likely than not to be realized on ultimate settlement. The cumulative effect of adopting FIN 48, if any, is recorded as an adjustment to the opening balance of retained earnings as of the adoption date.

The net income tax liabilities recognized under FIN 48 did not materially differ from the net assets recognized before adoption, and, therefore, the Company did not record an adjustment to retained earnings related to the adoption of FIN 48. At the adoption date of October 1, 2007, the Company had \$0.8 million of unrecognized tax benefits related to tax positions taken in prior periods, \$0.2 million of which would affect our effective tax rate if recognized. There were no material changes to the amount of unrecognized tax benefits during the first six months of fiscal 2008.

The Company recognized accrued interest and penalties related to unrecognized tax benefits in the Provision for Income Taxes. The Company had less than \$0.1 million accrued for interest and penalties as of March 31, 2008.

The Company files income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. With few exceptions, all U.S. federal, state and United Kingdom tax years between 1995 and 2007 remain open to examination due to net operating loss carryforwards and credit carryforwards. Tax years 2002 and later remain open to examination in the Netherlands, tax years 2003 and later remain open to examination in Canada and years 2004 and later remain open to examination in Germany.

An audit of the 2005 tax year is currently in process in the Netherlands. The Company does not expect resolution of this audit to have a material impact on our financial statements and the Company does not expect a significant increase or decrease in unrecognized tax benefits over the next 12 months.

The Company provides a valuation allowance for deferred tax assets when it is more likely than not that the net deferred tax assets will not be realized. Based on a number of factors, including the lack of a history of profits prior to 2007 and the fact that the market in which we compete is intensely competitive and characterized by rapidly changing technology, the Company believes that there is sufficient uncertainty regarding the realization of deferred tax assets such that a full valuation allowance has been provided. At March 31, 2008, the Company had approximately \$127.6 million and \$18.9 million of net operating loss carryforwards for federal and state purposes, respectively, and net operating loss carryforwards of approximately \$34.5 million in the United Kingdom. As a result of an IRC Section

382 study completed during fiscal 2008, it was determined that \$19.6 million of net operating loss carryforwards resulting from the acquisition of Prime Response will expire unutilized. The \$127.6 million in total federal net operating loss carryforwards is presented net of these Section 382 limitations. Upon being realized, the remaining \$13.8 million of the Prime Response federal net operating loss carryforwards would reduce goodwill and intangibles recorded at the date of acquisition before reducing the tax provision. Approximately \$3.5 million of additional net operating loss carryforwards are related to stock option deductions which, if utilized, would be accounted for as an addition to equity rather than as a reduction of the provision for income taxes. The net operating loss carryforwards are available to offset future federal and state taxable income and expire in years from 2008 through 2026. At March 31, 2008, there are approximately \$3.5 million of federal research and development credits and alternative minimum tax credits that expire in years 2011 through 2027. At March 31, 2008, there were also California state credits of approximately \$3.5 million that do not expire.

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NOTE 12—EMPLOYEE BENEFIT PLANS

2005 Equity Incentive Plan

As of March 31, 2008, there were approximately 2.5 million shares available for future grant and approximately 3.4 million options that were outstanding under the 2005 Equity Incentive Plan, or 2005 Plan. In December 2007, the Board amended the 2005 plan to increase the number of shares reserved for future issuance by 0.7 million shares. This amendment was approved by the stockholders at the 2008 Annual Meeting of Stockholders' held on February 1, 2008.

In October 2007, the Company granted 0.2 million performance-based Restricted Stock Units or RSUs to selected executives of the Company pursuant to the 2005 Plan. The performance-based RSUs cliff vest at the end of a two year requisite service period, constituting the Company's fiscal years 2008 and 2009, upon achievement of specified performance criteria established by the Compensation Committee of our Board of Directors. The award agreements for RSUs generally provide that vesting will be accelerated in certain events related to changes in control of the Company. Total compensation cost for these awards is based on the fair market value of the shares at the date of grant. The portion of the total compensation cost related to the performance-based awards is subject to adjustment each quarter based on management's assessment of the likelihood of achieving the two year performance criteria.

2000 Nonstatutory Equity Incentive Plan

As of March 31, 2008, there were approximately 0.4 million options outstanding under the 2000 Nonstatutory Equity Incentive Plan.

1999 Non-Employee Directors' Option Plan

As of March 31, 2008, there were approximately 0.2 million shares of common stock available for future grant and 0.2 million options that were outstanding under the 1999 Non-Employee Directors' Option Plan or Directors' Plan. In December 2007, the Board amended the Directors' Plan to incorporate the following changes:

1. expand the type of awards that may be granted under the Directors' Plan to allow Restricted Stock Awards (RSAs) and RSU awards; and
2. for fiscal year 2008 and thereafter, directors will be awarded RSAs instead of stock options for their annual and initial automatic Board service awards.

This amendment was approved by the stockholders at the 2008 Annual Meeting of Stockholders' held on February 1, 2008.

On February 1, 2008, the Company's Board members were granted 71,088 RSAs for their annual service award under the Directors' Plan. The RSAs cliff vest at the earlier of the date of the first anniversary of the most recent Annual Meeting or on the date of the next Annual meeting.

Stock Option Activity

The following table summarizes stock option, RSA, and RSUs activity under our stock option plans (in thousands, except per share data):



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|  | Shares<br>Available<br>for Grant | Shares | Options Outstanding<br>Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life<br>(Years) | Aggregate<br>Intrinsic<br>Value<br>Closing<br>Price at<br>3/31/2008<br>of \$6.03 |
|--|----------------------------------|--------|---|--|--|
| Balance at September 30, 2007                      | 3,058                            | 3,178  | \$ 7.96   |  |  |
| Authorized   | 700                              | —      | —   |  |  |
| Options granted                                    | (1,037)                          | 1,037  | 9.32  |  |  |
| Restricted stock awards granted                    | (71)                             | —      | —   |  |  |
| Restricted stock units granted *                   | (52)                             |        |   |  |  |
| Options exercised                                  | —                                | (98)   | 6.24  |  |  |
| Cancellation of unvested restricted stock          | —                                | —      | —   |  |  |
| Options and awards cancelled/forfeited             | 102                              | (102)  | 9.39  |  |  |
| Authorized reduction in shares from existing plans | (9)                              | —      | —   |  |  |
| Balance at March 31, 2008                          | 2,795                            | 4,015  | \$ 8.31   | 7.97   | \$ 1,164   |
| Vested and expected to vest at March 31, 2008      |                                  | 3,103  | \$ 8.16   | 7.70   | \$ 1,128   |
| Exercisable at March 31, 2008                      |                                  | 1,791  | \$ 7.53   | 6.72   | \$ 1,076   |

\* The number of RSUs granted is an estimate based upon management's assessment of the likelihood of achieving the two year performance criteria.

The following table summarizes information about stock options outstanding and exercisable at March 31, 2008 (in thousands, except exercise prices and contractual life data):

| Range of<br>Exercise Prices | Number<br>Outstanding | Options Outstanding  |  |  | Options Exercisable   |  |  |
|-----------------------------|-----------------------|--|--|--|-----------------------|--|--|
|                             |                       | Weighted<br>Average<br>Remaining<br>Contractual<br>Life<br>(Years) | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value<br>Closing<br>Price at<br>3/31/2008<br>of \$6.03 | Number<br>Exercisable | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value<br>Closing<br>Price at<br>3/31/08<br>of \$6.03 |
|                             |                       |  |  |  |                       |  |  |
|                             |                       |  |  |  |                       |  |  |
|                             |                       |  |  |  |                       |  |  |
| \$0.35 – 6.45               | 635                   | 5.89   | \$ 4.21                                  | \$ 1,164   | 495                   | \$ 3.87                                  | \$ 1,076   |
| 6.48 – 7.80                 | 536                   | 7.33   | 7.17                                     | —  | 349                   | 7.08                                     | —  |
| 7.88 – 8.15                 | 439                   | 7.69   | 7.98                                     | —  | 235                   | 7.98                                     | —  |
| 8.25 – 8.25                 | 802                   | 8.81   | 8.25                                     | —  | 246                   | 8.25                                     | —  |
| 8.28 – 9.13                 | 201                   | 7.94   | 8.51                                     | —  | 87                    | 8.56                                     | —  |
| 9.25 – 9.25                 | 799                   | 9.62   | 9.25                                     | —  | 77                    | 9.25                                     | —  |
| 9.26 – 45.00                | 603                   | 7.60   | 12.67                                    | —  | 302                   | 12.39                                    | —  |

|                |       |      |    |      |    |       |       |    |      |    |       |
|----------------|-------|------|----|------|----|-------|-------|----|------|----|-------|
| \$0.35 – 45.00 | 4,015 | 7.97 | \$ | 8.31 | \$ | 1,164 | 1,791 | \$ | 7.53 | \$ | 1,076 |
|----------------|-------|------|----|------|----|-------|-------|----|------|----|-------|

The aggregate intrinsic value in the preceding table represents the total intrinsic value, based on the Company's closing stock price of \$6.03 as of March 31, 2008, which would have been received by the option holders had all option holders exercised their options as of that date. The total intrinsic value of options exercised during the three and six months ended March 31, 2008 was less than \$0.1 million and \$0.7 million, respectively, and \$4.0 million and \$4.3 million for the three and six months ended March 31, 2007, respectively. The fair value of options vested was \$0.1 million and \$0.8 million for the three and six months ended March 31, 2008 and \$0.3 million and \$0.9 million for the three and six months ended March 31, 2007, respectively. As of March 31, 2008, total unrecognized compensation costs related to non-vested stock options was \$6.3 million, which is expected to be recognized as expense over a weighted-average period of approximately 2.8 years. As of March 31, 2007, total unrecognized compensation costs related to non-vested stock options was \$5.7 million, which was expected to be recognized as expense over a weighted-average period of approximately 1.5 years.

On February 1, 2008, the Company's Board members were granted 71,088 RSAs for their annual service award under the Directors' Plan. The Company had 0.1 million unvested RSAs as of March 31, 2008, which were excluded from the preceding tables. The total fair value of the unvested RSAs at grant date was \$0.6 million. Aggregate intrinsic value of the unvested RSAs at March 31, 2008 was \$0.4 million. During the three months ended March 31, 2008, zero shares vested related to RSAs. The weighted average fair value at grant date of the unvested RSAs was \$8.44 per share as of March 31, 2008. As of March 31, 2008,

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total unrecognized compensation costs related to unvested RSAs was \$0.5 million which is expected to be recognized as expense over a weighted average period of approximately 0.8 year.

The Company had 0.1 million unvested RSAs as of March 31, 2007. The total fair value of the unvested RSAs at grant date was \$0.4 million. Aggregate intrinsic value of the unvested RSAs at March 31, 2007 was \$0.9 million. During the three and six months ended March 31, 2007, approximately 0.1 million and 0.2 million shares vested related to RSAs, respectively. There were no shares of restricted stock awarded during the three and six months ended March 31, 2007. The weighted average fair value at grant date of the unvested RSAs was \$5.25 as of March 31, 2007. As of March 31, 2007, total unrecognized compensation costs related to unvested RSAs was less than \$0.1 million which is expected to be recognized as expense over a weighted average period of approximately 0.3 years.

As of March 31, 2008, the total fair value and number of vested RSUs was zero. Based upon management's assessment of the likelihood of achieving the two year performance criteria, the Company has less than 0.1 million out of a maximum of 0.2 million of unvested RSUs with an average fair value of \$15.38 per unit. During the six months ended March 31, 2008, \$0.2 million of stock compensation expense related to the performance-based RSUs has been recognized. The total unrecognized compensation costs related to unvested RSUs was \$0.6 million which is expected to be recognized as expense over a weighted average period of approximately 18 months. If the maximum target of RSUs outstanding were assumed to be earned, total unrecognized compensation costs would be approximately \$3.1 million which would be expected to be recognized as expense over a weighted average period of approximately 18 months.

The Company settles stock option exercises, RSAs and RSUs with newly issued common shares.

#### Valuation and Expense Information under SFAS 123(R)

On October 1, 2005, the Company adopted SFAS 123(R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to the Company's employees and directors including employee stock options, RSAs, RSUs and employee stock purchases related to the Employee Stock Purchase Plan based on estimated fair values. The following table summarizes stock-based compensation expense related to employee stock options, RSA and RSUs for the three and six months ended March 31, 2008 and 2007, respectively, which was allocated as follows (in thousands):

|  | Three Months Ended March 31, |        | Six Months Ended March 31, |          |
|--|------------------------------|--------|----------------------------|----------|
|  | 2008                         | 2007   | 2008                       | 2007     |
| Stock-based compensation expense:      |                              |        |                            |          |
| Cost of revenues, service              | \$ 109                       | \$ 54  | \$ 262                     | \$ 161   |
| Sales and marketing                    | 230                          | 237    | 471                        | 566      |
| Research and development               | 144                          | 168    | 343                        | 262      |
| General and administrative             | 498                          | 434    | 1,081                      | 880      |
| Total stock-based compensation expense | \$ 981                       | \$ 893 | \$ 2,157                   | \$ 1,869 |

The weighted-average estimated fair value of stock options granted during the three months ended March 31, 2008 and 2007 was \$2.96 and \$4.07 per share, respectively, and for the six months ended March 31, 2008 and 2007 was



\$4.30 and \$4.06, respectively, using the Black-Scholes model with the following weighted-average assumptions:

|                          | Three Months Ended March 31, |      | Six Months Ended March 31, |      |
|--------------------------|------------------------------|------|----------------------------|------|
|                          | 2008                         | 2007 | 2008                       | 2007 |
| Expected lives in years  | 3.7                          | 3.5  | 3.5                        | 3.5  |
| Risk free interest rates | 2.3%                         | 4.8% | 3.3%                       | 4.7% |
| Volatility               | 61%                          | 63%  | 60%                        | 63%  |
| Dividend yield           | 0%                           | 0%   | 0%                         | 0%   |

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model with the weighted-average assumptions for volatility, expected term, and risk free interest rate. With the adoption of SFAS 123(R) on October 1, 2005, the Company used the trinomial lattice valuation technique to determine the assumptions used in the Black-Scholes model. The trinomial lattice valuation technique was used to provide a better estimate of fair values and meet the fair value objectives of SFAS 123(R). The expected term of options granted is derived from historical data on employee exercises and post-vesting employment termination behavior. The risk-free rate is based on the U.S. Treasury rates in effect during the corresponding period of grant. The expected volatility rate is based on the historical volatility of our stock price.

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As stock-based compensation expense recognized in the Condensed Consolidated Statements of Operations for the three and six months ended March 31, 2008 and 2007 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Our estimated forfeiture rate for the three and six months ended March 31, 2008 and 2007 was based on our historical forfeiture experience.

#### Accuracy of Fair Value Estimates

The Company uses third-party analyses to assist in developing the assumptions based on a trinomial lattice valuation technique used in the Black-Scholes model. The Company is responsible for determining the assumptions used in estimating the fair value of share-based payment awards.

Our determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the Company's expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. Because the Company's employee stock options have certain characteristics that are significantly different from traded options, and because changes in the subjective assumptions can materially affect the estimated value, in management's opinion, the existing valuation models may not provide an accurate measure of the fair value of the Company's employee stock options and RSAs. Although the fair value of employee stock options and RSAs is determined in accordance with SFAS 123(R) and SAB 107 using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

#### NOTE 13—SEGMENT INFORMATION

Our chief operating decision maker reviews financial information presented on a consolidated basis, accompanied by desegregated information about revenues by geographic regions for purposes of making operating decisions and assessing financial performance. Accordingly, the Company has concluded that the Company has one reportable segment.

The following table summarizes license revenue by product emphasis (in thousands):

|                               | Three Months Ended March 31, |           | Six Months Ended March 31, |           |
|-------------------------------|------------------------------|-----------|----------------------------|-----------|
|                               | 2008                         | 2007      | 2008                       | 2007      |
| License Revenue:              |                              |           |                            |           |
| Enterprise solutions          | \$ 3,870                     | \$ 12,619 | \$ 10,084                  | \$ 16,164 |
| Marketing solutions           | 579                          | 1,268     | 1,293                      | 2,257     |
| Decision management solutions | 358                          | 4,995     | 2,237                      | 7,623     |
| Total                         | \$ 4,807                     | \$ 18,882 | \$ 13,614                  | \$ 26,044 |

The following table summarizes service revenue consisting of consulting implementation and integration, consulting customization, training, post-contract customer support services, or PCS and certain reimbursable out-of-pocket expenses by product emphasis (in thousands):

Three Months Ended March 31,      Six Months Ended March 31,

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|                               | 2008      | 2007      | 2008      | 2007      |
|-------------------------------|-----------|-----------|-----------|-----------|
| Service Revenue:              |           |           |           |           |
| Enterprise solutions          | \$ 13,439 | \$ 10,147 | \$ 28,649 | \$ 22,346 |
| Marketing solutions           | 3,070     | 2,903     | 6,188     | 5,508     |
| Decision management solutions | 3,400     | 833       | 5,399     | 1,806     |
| Total                         | \$ 19,909 | \$ 13,883 | \$ 40,236 | \$ 29,660 |

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

|               | Three Months Ended March 31, |           | Six Months Ended March 31, |           |
|---------------|------------------------------|-----------|----------------------------|-----------|
|               | 2008                         | 2007      | 2008                       | 2007      |
| North America | \$ 14,671                    | \$ 9,473  | \$ 30,262                  | \$ 22,694 |
| Europe        | 10,045                       | 23,292    | 23,588                     | 33,010    |
| Total         | \$ 24,716                    | \$ 32,765 | \$ 53,850                  | \$ 55,704 |

Included in foreign revenue results for Europe is revenue from the United Kingdom of \$6.0 million and \$12.1 million for the three and six months ended March 31, 2008 and \$9.5 and \$15.8 million for the three and six months ended March 31, 2007, respectively.

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

|               | March 31,<br>2008 | September<br>30,<br>2007 |
|---------------|-------------------|--------------------------|
| North America | \$ 2,519          | \$ 2,346                 |
| Europe        | 1,232             | 1,292                    |
| Total         | \$ 3,751          | \$ 3,638                 |

## NOTE 14—STOCK REPURCHASE

On February 28, 2008, the Company's Board of Directors authorized a program to repurchase up to \$25 million of the Company's common stock over a one year period, or 2008 Repurchase Plan, starting on March 4, 2008. In conjunction with the 2008 Repurchase Plan, the Company entered into a written trading plan with a broker under Rule 10b5-1 of the Securities Exchange Act of 1934, as amended, to effect the repurchases. Repurchased shares are immediately retired and will resume the status of authorized but unissued shares. As of March 31, 2008, the Company had repurchased 1.5 million shares of our common stock for \$9.3 million at an average price of \$6.10 per share. The Company terminated the 2008 Stock Repurchase Plan as of April 30, 2008. Subsequent to March 31, 2008, through April 30, 2008, the Company had repurchased an additional 1.8 million shares of our common stock for \$9.3 million at an average price of \$5.09 per share. As of April 30, 2008, the Company had repurchased a total of 3.4 million shares of our common stock for \$18.6 million at an average price of \$5.55 per share.

## NOTE 15—SUBSEQUENT EVENT

On May 1, 2008, the Company committed to a cost reduction plan intended to align its resources and cost structure with expected future revenues. The plan anticipates a re-allocation of employee resources between functional groups. The plan includes an immediate reduction in positions equal to approximately ten percent of the Company's worldwide

workforce. We notified employees on May 1, 2008.

As a result of the cost-cutting measures, the Company estimates that it will record pre-tax operating charges in the third quarter of fiscal year 2008 of approximately \$0.4 million for severance costs.

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### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

This discussion and analysis should be read in conjunction with our Condensed Consolidated Financial Statements and accompanying Notes included in this report and the 2007 Audited Financial Statements and Notes thereto included in our Annual Report on Form 10-K for the year ended September 30, 2007 filed with the SEC. Operating results are not necessarily indicative of results that may occur in future periods.

The following discussion and analysis contains forward-looking statements. These statements are based on our current expectations, assumptions, estimates and projections about our business and our industry, and involve known and unknown risks, uncertainties and other factors that may cause our or our industry's results, levels of activity, performance or achievement to be materially different from any future results, levels of activity, performance or achievements expressed or implied in or contemplated by the forward-looking statements. Words such as "believe," "anticipate," "expect," "intend," "plan," "will," "may," "should," "estimate," "predict," "guidance," "potential," "continue" or such terms or other similar expressions, identify forward-looking statements. Our actual results and the timing of events may differ significantly from those discussed in the forward-looking statements as a result of various factors, including but not limited to, those discussed under the subheading "Risk Factors" and those discussed elsewhere in this report, in our other SEC filings and under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our 2007 Form 10-K. Chordiant undertakes no obligation to update any forward-looking statement to reflect events after the date of this report.

#### Overview

As an enterprise software vendor, we generate substantially all of our revenues from the banking, insurance, healthcare, telecommunications, and retail industries. Our customers typically fund purchases of our software and services out of their lines of business and information technology budgets. As a result, our revenues are heavily influenced by our customers' long-term business outlook and willingness to invest in new enterprise information systems and business applications.

For the three months ended March 31, 2008, total revenues decreased 25% and backlog increased 19% as compared to the same period of the prior year. For the three months ended March 31, 2008, backlog decreased \$2.5 million or 3% compared to the balance at December 31, 2007. This decrease in backlog is primarily related to a reduction of license and support and maintenance deferred revenue balances at the end of the quarter.

#### Software Industry Consolidation and Possible Increased Competition

The enterprise software industry continues to undergo consolidation in sectors of the software industry in which we operate. In 2007 and 2008 IBM acquired Cognos, DataMirror and Watchfire Corporation; Oracle completed its acquisition of Hyperion and Moniforce and has entered into an agreement to purchase BEA Systems; Sun Microsystems has entered in an agreement to purchase MySQL and SAP acquired BusinessObjects, YASU Technologies and Pilot Software. While we do not believe that Cognos, DataMirror, Watchfire Corporation, Hyperion, Moniforce, BEA Systems, MySQL, BusinessObjects, YASU Technologies, or Pilot Software have been significant competitors of Chordiant in the past, the acquisition of these companies by IBM, Oracle, Sun Microsystems and SAP may indicate that we will face increased competition from larger and more established entities in the future.

#### Financial Trends

**Backlog.** Our revenues have primarily been derived from large customer transactions. For some of these transactions, the associated professional services provided to the customer can span over a period greater than one year. If the services delivery period is over multiple quarters, it will cause the associated backlog to be recognized as revenue over

a similar period of time. As of March 31, 2008 and 2007, we had approximately \$93.5 million and \$78.6 million in backlog, respectively, which we define as contractual commitments by our customers through purchase orders or contracts. Backlog at March 31, 2008 includes approximately \$26.1 million relating to a large telecommunications customer commitment. For the period ended March 31, 2008 as compared to the previous period ended December 31, 2007, aggregate deferred revenue balances decreased \$2.0 million due to a decrease of \$2.2 million in long-term deferred revenue offset by an increase of \$0.2 million in short-term deferred revenue. Backlog is comprised of:

• software license orders for which the delivered products have not been accepted by customers or have not otherwise met all of the required criteria for revenue recognition. This component includes billed amounts classified as deferred revenue;

- deferred revenue from customer support contracts; and,

• consulting service orders representing the unbilled remaining balances of consulting contracts not yet completed or delivered, plus deferred consulting revenue where we have not otherwise met all of the required criteria for revenue recognition.

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Backlog is not necessarily indicative of revenues to be recognized in a specified future period. There are many factors that would impact Chordiant's conversion of backlog as recognizable revenue, such as Chordiant's progress in completing projects for its customers, Chordiant's customers' meeting anticipated schedules for customer-dependent deliverables and customers increasing the scope or duration of a contract causing license revenue to be deferred for a longer period of time.

Chordiant provides no assurances that any portion of its backlog will be recognized as revenue during any fiscal year or at all, or that its backlog will be recognized as revenues in any given period. In addition, it is possible that customers from whom we expect to derive revenue from backlog will default and as a result we may not be able to recognize expected revenue from backlog.

Implementation by Third Parties. Over time as our products mature and system integrators become more familiar with our products, our involvement with implementations has diminished on some projects. If this trend continues, certain agreements with customers may transition from a contract accounting model (SOP81-1) to a more traditional revenue model whereby revenues are recorded upon delivery (SOP 97-2).

Service Revenue. Service revenue as a percentage of total revenues were 81% and 42% for the three months ended March 31, 2008 and 2007, respectively, and 75% and 53% for the six months ended March 31, 2008 and 2007, respectively. While the composition of revenue will continue to fluctuate on a quarterly basis, we expect that service revenue will represent between 50% and 60% of our total revenues in the future.

Revenues from International Customers versus North America Revenues. For all periods presented, revenues were principally derived from customer accounts in North America and Europe. For the three months ended March 31, 2008 and 2007, international revenues were \$10.0 million and \$23.3 million, or approximately 41% and 71% of our total revenues, respectively. For the six months ended March 31, 2008 and 2007, international revenues were \$23.6 million and \$33.0 million, or approximately 44% and 59% of our total revenues, respectively. The decrease in international revenue for the three and six months ended March 31, 2008 was primarily due to a decrease in license revenue. During the March 31, 2007 quarter, a large customer transaction was recognized as revenue. International revenues were favorably impacted for the three months ended March 31, 2008, as compared to the three months ended March 31, 2007, as both the British Pound and the Euro increased in average value by approximately 1% and 14%, respectively, as compared to the U.S. Dollar.

For the three months ended March 31, 2008 and 2007, North America revenues were \$14.7 million and \$9.5 million, or approximately 59% and 29% of our total revenues, respectively. For the six months ended March 31, 2008 and 2007, North America revenues were \$30.3 million and \$22.7 million, or approximately 56% and 41% of total revenues, respectively. We believe North America revenues will continue to represent a significant portion of our total revenues in the foreseeable future.

Gross Margins. Management focuses on license and service gross margin in evaluating our financial condition and operating performance. Gross margins on license revenues were 94% and 97% for the three months ended March 31, 2008 and 2007, respectively, and 95% and 96% for the six months ended March 31, 2008 and 2007. The 1 % decrease for the quarter ending March 31, 2008 is primarily a function of the fixed periodic amortization costs associated with capitalized software being divided by a smaller license amount quarter-over-quarter. We expect license gross margin on current products to range from 95% to 97% in the foreseeable future. The margin will fluctuate with the mix of products sold. Historically, the enterprise solution products have higher associated third party royalty expense than the marketing solution products and decision management products.



Gross margins on service revenue were 57% and 60% for the three months ended March 31, 2008 and 2007, respectively and 58% and 56% for the six months ended March 31, 2008 and 2007, respectively. The decrease in gross margins for the three months period ending March 31, 2008 is primarily due to the mix of consulting revenue versus support revenue. Consulting revenue, which has a lower gross margin than support revenue, increased to a larger percentage of total service revenue reducing the overall gross margin. We expect that gross margins on service revenue to range between 55% and 60% in the second half of fiscal year 2008.

**Costs Related to Stock Option Investigation.** For the three and six months ended March 31, 2007, significant professional service costs are included in general and administrative expense associated with the Company's stock option investigation which began in July 2006 and was completed during the quarter ended March 2007. This issue is more fully described in the Note 2 of the Consolidated Financial Statements in our 2006 Form 10-K. For the three and six months ended March 31, 2007, these costs were \$0.8 million and \$1.8 million, respectively. We have not incurred any additional costs since the quarter ended March 31, 2007 and do not expect to incur such costs in the future periods.

**Cost to Amend Eligible Options.** In July 2006, our Board of Directors, or the Board, initiated a review of our historical stock option grant practices and appointed the Audit Committee to oversee the investigation. The Audit Committee determined that the correct measurement dates for a number of stock option grants made by us during the period 2000 to 2006, or Review

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Period, differed from the measurement dates previously used to account for such option grants. The Audit Committee identified errors related to the determination of the measurement dates for grants of options where the price of our common stock on the selected grant date was lower than the price on the actual grant date which would permit recipients to exercise these options at a lower exercise price. As such, these affected stock options are deemed, for accounting purposes, to have been granted at a discount. Based on the determination made for accounting purposes, the discounted options (for accounting purposes) may now be deemed to have been granted at a discount for tax purposes, which may expose the holders of these impacted stock option grants to potentially adverse tax treatment under Section 409A of the Internal Revenue Code and state law equivalents. As more fully described on Form SC TO-I filed with the SEC on March 29, 2007, Chordiant offered certain optionees the opportunity to increase the exercise price of the discounted options to limit the potential adverse personal tax consequences that may apply to those stock options under Section 409A of the Internal Revenue Code and state law equivalents. On April 26, 2007, eligible optionees finalized their elections under the offer and were awarded a future cash payment equal to the price differential of the Amended Options. These payments were treated as bonus payments. These cash payments were approximately \$0.3 million and were paid out in January 2008.

**Reduction in Workforce.** In October 2006, we initiated a restructuring plan intended to align our resources and cost structure with expected future revenues. The restructuring plan included a balancing of services resources worldwide, an elimination of duplicative functions internationally, and a shift in the U.S. field organization toward a focus on domain-based sales and pre-sales teams.

The restructuring plan included an immediate reduction in positions of slightly more than ten percent of our workforce, the consolidation of our European facilities, and the closure of our France office. A majority of the positions eliminated were in Europe. The plan was committed to on October 24, 2006, and we began notifying employees on October 25, 2006.

We initially recorded a pre-tax cash restructuring expense of \$6.5 million as calculated using the net present value of the related costs as required by SFAS 146. The expense was composed of costs for severance and exiting excess facilities. During the three months ended March 31, 2007, we incurred an additional charge of \$0.1 million for employee severance costs associated with the closure of our France office. Also during the three months ended March 31, 2007, we negotiated an early termination of the France office lease associated with its closure, resulting in a \$0.2 million reduction in the excess facility liability. This reduction was recorded as an offset to restructuring expense in the period. In November 2007, we negotiated a break clause in the lease allowing for an early termination of the United Kingdom facility which released us from any future rent liabilities subsequent to January 2008. All termination payments have now been made.

In July 2005, we undertook an approximate 10% reduction in our workforce. In connection with this action, we incurred a one-time cash expense of approximately \$1.1 million in the fourth quarter ended September 30, 2005 for severance benefits. As of March 31, 2008, \$0.1 million of the cash charges remains outstanding.

During fiscal year 2002, we restructured several areas of the Company to reduce expenses and improve revenues. As part of this restructuring, we closed an office facility in Boston, Massachusetts and recorded an expense associated with the long-term lease which expires in January 2011. During the three months ended March 31, 2007, we completed a new sublease with a sub-lessee for the remaining term of our lease at a rate lower than that which was forecasted when the original restructuring expense was recorded in 2002. This change in estimate resulted in a \$0.3 million restructuring expense for the year ended September 30, 2007.

**Past Results may not be Indicative of Future Performance.** We believe that period-to-period comparisons of our operating results should not be relied upon as indicative of future performance. Our prospects must be considered given the risks, expenses and difficulties frequently encountered by companies in early stages of development,

particularly companies in rapidly evolving businesses. There can be no assurance we will be successful in addressing these risks and difficulties. Moreover, we may not achieve or maintain profitability in the future.

#### Critical Accounting Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our Condensed Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities.

On an on-going basis, we evaluate the estimates, including those related to our allowance for doubtful accounts, valuation of stock-based compensation, valuation of goodwill and intangible assets, valuation of deferred tax assets, restructuring expenses, contingencies, vendor specific objective evidence, or VSOE, of fair value in multiple element arrangements and the estimates associated with the percentage-of-completion method of accounting for certain of our revenue contracts. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the recognition of revenue and expenses that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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We believe the following critical accounting judgments and estimates are used in the preparation of our Condensed Consolidated Financial Statements:

- Revenue recognition, including estimating the total estimated time required to complete sales arrangements involving significant implementation or customization essential to the functionality of our products;
- Estimating valuation allowances and accrued liabilities, specifically the allowance for doubtful accounts, and assessment of the probability of the outcome of our current litigation;
- Stock-based compensation expense;
- Accounting for income taxes;
- Valuation of long-lived and intangible assets and goodwill;
- Restructuring expenses; and
- Determining functional currencies for the purposes of consolidating our international operations.

**Revenue Recognition.** We derive revenues from licenses of our software and related services, which include assistance in implementation, customization and integration, post-contract customer support, training and consulting. The amount and timing of our revenue is difficult to predict and any shortfall in revenue or delay in recognizing revenue could cause our operating results to vary significantly from quarter to quarter and could result in operating losses. The accounting rules related to revenue recognition are complex and are affected by interpretation of the rules and an understanding of industry practices, both of which are subject to change. Consequently, the revenue recognition accounting rules require management to make significant estimates based on judgment.

Software license revenue is recognized in accordance with the AICPA’s Statement of Position No. 97-2 “Software Revenue Recognition,” as amended by Statement of Position No. 98-9 “Software Revenue Recognition with Respect to Certain Arrangements”, or collectively SOP 97-2.

For arrangements with multiple elements, we recognize revenue for services and post-contract customer support based upon the fair value VSOE of the respective elements. The fair value VSOE of the services element is based upon the standard hourly rates we charge for the services when such services are sold separately. The fair value VSOE for annual post-contract customer support is generally established with the contractual future renewal rates included in the contracts, when the renewal rate is substantive and consistent with the fees when support services are sold separately. When contracts contain multiple elements and fair value VSOE exists for all undelivered elements, we account for the delivered elements, principally the license portion, based upon the “residual method” as prescribed by SOP 97-2. In multiple element transactions where VSOE is not established for an undelivered element, we recognize revenue upon the establishment of VSOE for that element or when the element is delivered.

At the time we enter into a transaction, we assess whether any services included within the arrangement related to significant implementation or customization essential to the functionality of our products. For contracts for products that do not involve significant implementation or customization that is essential to the product functionality, we recognize license revenues when there is persuasive evidence of an arrangement, the fee is fixed or determinable, collection of the fee is probable and delivery has occurred as prescribed by SOP 97-2. For contracts that involve significant implementation or customization essential to the functionality of our products, we recognize the license and professional consulting services revenue using either the percentage-of-completion method or the completed

contract method as prescribed by Statement of Position No. 81-1, “Accounting for Performance of Construction-Type and Certain Product-Type Contracts”, or SOP 81-1.

The percentage-of-completion method is applied when we have the ability to make reasonably dependable estimates of the total effort required for completion using labor hours incurred as the measure of progress towards completion. The progress toward completion is measured based on the “go-live” date. We define the “go-live” date as the date the essential product functionality has been delivered or the application enters into a production environment or the point at which no significant additional Chordiant supplied professional service resources are required. Estimates are subject to revisions as the contract progresses to completion. We account for the changes as changes in accounting estimates when the information becomes known. Information impacting estimates obtained after the balance sheet date but before the issuance of the financial statements is used to update the estimates. Provisions for estimated contract losses, if any, are recognized in the period in which the loss becomes probable and can be reasonably estimated. When we sell additional licenses related to the original licensing agreement, revenue is recognized upon delivery if the project has reached the go-live date, or if the project has not reached the go-live date, revenue is recognized under the percentage-of-completion method. We classify revenues from these arrangements as license and service revenue based upon the estimated fair value of each element using the residual method.

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The completed contract method is applied when we are unable to obtain reasonably dependable estimates of the total effort required for completion. Under the completed contract method, all revenue and related costs of revenue are deferred and recognized upon completion.

For product co-development arrangements relating to software products in development prior to the consummation of the individual arrangements where we retain the intellectual property being developed and intend to sell the resulting products to other customers, license revenue is deferred until the delivery of the final product, provided all other requirements of SOP 97-2 are met. Expenses associated with these co-development arrangements are accounted for under SFAS 86 and are normally expensed as incurred as they are considered to be research and development costs that do not qualify for capitalization or deferral.

Revenue from subscription or term license agreements, which include software and rights to unspecified future products or maintenance, is recognized ratably over the term of the subscription period. Revenue from subscription or term license agreements, which include software, but exclude rights to unspecified future products and maintenance, is recognized upon delivery of the software if all conditions of recognizing revenue have been met including that the related agreement is non-cancelable, non-refundable and provided on an unsupported basis.

For transactions involving extended payment terms, we deem these fees not to be fixed or determinable for revenue recognition purposes and revenue is deferred until the fees become payable and due.

For arrangements with multiple elements accounted for under SOP 97-2 where we determine we can account for the elements separately and the fees are not fixed or determinable due to extended payment terms, revenue is recognized in the following manner. If the undelivered element is PCS, or other services, an amount equal to the estimated value of the services to be rendered prior to the next payment becoming due is allocated to the undelivered services. The residual of the payment is allocated to the delivered elements of the arrangement.

For arrangements with multiple elements accounted for under SOP 81-1 where we determine we can account for the elements separately and the fees are not fixed or determinable due to extended payment terms, revenue is recognized in the following manner. Amounts are first allocated to the undelivered elements included in the arrangement, as payments become due or are received, the residual is allocated to the delivered elements.

We recognize revenue for post-contract customer support ratably over the support period which ranges from one to five years.

Our training and consulting services revenues are recognized as such services are performed on an hourly or daily basis for time and material contracts. For consulting services arrangements with a fixed fee, we recognize revenue on a percentage-of-completion method.

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

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

upon the receipt of cash.

**Allowance for Doubtful Accounts.** We must make estimates of the uncollectability of our accounts receivables. We specifically analyze accounts receivable and analyze historical bad debts, customer concentrations, customer credit-worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. Generally, we require no collateral from our customers. Our gross accounts receivable balance was \$26.2 million (including long-term accounts receivable of \$0.1 million) with an allowance for doubtful accounts of \$0.2 million as of March 31, 2008. Our gross accounts receivable balance was \$28.5 million (including long-term accounts receivable of \$1.0 million) with an allowance for doubtful accounts of \$0.2 million as of September 30, 2007. 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. To date, bad debts have not been material and have been within management's expectations.

**Stock-based Compensation Expense.** Upon adoption of SFAS 123(R) on October 1, 2005, we began estimating the value of employee stock awards on the date of grant using the Black-Scholes model. Prior to the adoption of SFAS 123(R), the value of each employee stock award was estimated on the date of grant using the Black-Scholes model for the purpose of the pro forma financial disclosure in accordance with SFAS 123. The determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors.

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With the adoption of SFAS 123(R) on October 1, 2005, we used the trinomial lattice valuation technique to determine the assumptions used in the Black-Scholes model. The trinomial lattice valuation technique was used to provide better estimates of fair values and meet the fair value objectives of SFAS 123(R). The expected term of options granted is derived from historical data on employee exercises and post-vesting employment termination behavior. The expected volatility is based on the historical volatility of our stock.

As stock-based compensation expense recognized in the Condensed Consolidated Statement of Operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience.

If factors change and we employ different assumptions in the application of SFAS 123(R) in future periods, the compensation expense that we record under SFAS 123(R) may differ significantly from what we have recorded in the current period. The estimated value of a stock option is most sensitive to the volatility assumption. Based on the March 31, 2008 variables, it is estimated that a change of 10% in either the volatility, expected life or interest rate assumption would result in a corresponding 8%, 5% or 1% change, respectively, in the estimated value of the option being valued using the Black-Scholes model.

As stock-based compensation expense attributable to performance restricted stock units, or RSUs, is based on management's assessment of the likelihood of achieving certain criteria, the amount of expense that is recorded in a period is dependent on the accuracy of management's estimates. It is estimated that a 5% change in management's achievement estimates would result in a corresponding 52% change in the stock compensation expense recorded for the period. The RSUs granted vest at the end of fiscal year 2009 if certain specified performance criteria are achieved. It is expected that estimates will become more accurate leading up to September 30, 2009.

**Accounting for Income Taxes.** As part of the process of preparing our Condensed Consolidated Financial Statements we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as deferred revenue, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our Condensed Consolidated Balance Sheets. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we must include an expense within the tax provision in the Statement of Operations.

We have recorded a valuation allowance equal to 100% of the deferred tax assets as of March 31, 2008, due to uncertainties related to our ability to utilize our net deferred tax assets, primarily consisting of certain net operating loss carryforwards, research and development credits and temporary differences relating to deferred revenue. Deferred tax assets have been fully reserved for in all periods presented.

Effective October 1, 2007, the Company adopted Financial Accounting Standards Interpretation, No. 48 "Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109" or FIN 48. FIN 48 prescribes a recognition threshold and measurement guidance for the financial statement reporting of uncertain tax positions taken or expected to be taken in a company's income tax return. The application of FIN 48 is discussed in Note 11 to the Condensed Consolidated Financial Statements.

**Valuation of Long-lived and Intangible Assets and Goodwill.** We assess the impairment of identifiable intangibles and long-lived assets whenever events or changes in circumstances indicate that the carrying value may not be



recoverable. Furthermore, we assess the impairment of goodwill annually. Factors we consider important which could trigger an impairment review include the following:

- Significant underperformance relative to expected historical or projected future operating results;
- Significant changes in the manner of our use of the acquired assets or the strategy for our overall business;
  - Significant negative industry or economic trends;
  - Significant decline in our stock price for a sustained period;
  - Market capitalization declines relative to net book value; and

• A current expectation that, more likely than not, a long-lived asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

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When one or more of the above indicators of impairment occurs we estimate the value of long-lived assets and intangible assets to determine whether there is impairment. We measure any impairment based on the projected discounted cash flow method, which requires us to make several estimates including the estimated cash flows associated with the asset, the period over which these cash flows will be generated and a discount rate commensurate with the risk inherent in our current business model. These estimates are subjective and if we made different estimates, it could materially impact the estimated fair value of these assets and the conclusions we reached regarding impairment. To date, we have not identified any triggering events noted above. While the recent decline in our stock price and negative economic trends have lowered our market capitalization at March 31, 2008, our market capitalization is still at the levels significantly higher than our book value.

We are required to perform an impairment review of our goodwill balance on at least an annual basis. This impairment review involves a two-step process as follows:

Step 1—We compare the fair value of our reporting units to the carrying value, including goodwill, of each of those units. For each reporting unit where the carrying value, including goodwill, exceeds the unit's fair value, we proceed on to Step 2. If a unit's fair value exceeds the carrying value, no further work is performed and no impairment charge is necessary.

Step 2—We perform an allocation of the fair value of the reporting unit to our identifiable tangible and non-goodwill intangible assets and liabilities. This derives an implied fair value for the reporting unit's goodwill. We then compare the implied fair value of the reporting unit's goodwill with the carrying amount of the reporting unit's goodwill. If the carrying amount of the reporting unit's goodwill is greater than the implied fair value of its goodwill, an impairment charge would be recognized for the excess.

We determined that we have one reporting unit. We completed a goodwill impairment review for the period ending September 30, 2007 and performed Step 1 of the goodwill impairment analysis required by SFAS 142, "Goodwill and Other Intangible Assets," and concluded that goodwill was not impaired as of September 30, 2007 using the methodology described above. Accordingly, Step 2 was not performed. We will continue to test for impairment on an annual basis and on an interim basis if an event occurs or circumstances change that would more likely than not reduce the fair value of our reporting units below their carrying amount.

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

**Determining Functional Currencies for the Purpose of Consolidation.** We have several foreign subsidiaries that together account for a significant portion of our revenues, expenses, assets and liabilities.

In preparing our Condensed Consolidated Financial Statements, we are required to translate the financial statements of the foreign subsidiaries from the currency in which they keep their accounting records, generally the local currency,

into United States dollars. This process results in exchange gains and losses which, under the relevant accounting guidance are either included within the Condensed Consolidated Statement of Operations or as a separate part of our net equity under the caption “Accumulated Other Comprehensive Income.” Under the relevant accounting guidance, the treatment of these translation gains or losses is dependent upon our management’s determination of the functional currency of each subsidiary. The functional currency is determined based on management’s judgment and involves consideration of all relevant economic facts and circumstances affecting the subsidiary. Generally, the currency in which the subsidiary conducts a majority of its transactions, including billings, financing, payroll and other expenditures would be considered the functional currency but any dependency upon the parent and the nature of the subsidiary’s operations must also be considered.

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

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Based on our assessment of the factors discussed above, we consider the relevant subsidiary's local currency to be the functional currency for each of our international subsidiaries. Accordingly, foreign currency translation gains and losses are included as part of Accumulated Other Comprehensive Income within our Condensed Consolidated Balance Sheets for all periods presented.

The magnitude of these gains or losses is dependent upon movements in the exchange rates of the foreign currencies in which we transact business against the United States dollar. These currencies include the United Kingdom Pound Sterling, the Euro and the Canadian Dollar. Any future translation gains or losses could be significantly larger or smaller than those reported in previous periods. At March 31, 2008, approximately \$41.7 million of our cash and cash equivalents were held by our subsidiaries outside of the United States.

Recent Accounting Pronouncements

See Note 2 to the Condensed Consolidated Financial Statements under section "Recent Accounting Pronouncements" for detailed information regarding status of new accounting standards that are not yet effective for us.

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## Results of Operations

The following table sets forth, in dollars and as a percentage of total revenues, unaudited Condensed Consolidated Statements of Operations data for the periods indicated. This information has been derived from the Condensed Consolidated Financial Statements included elsewhere in this Quarterly Report (in thousands, except percentages):

|   | Three Months Ended March 31, |      |           |     | Six Months Ended March 31, |      |            |       |
|---|------------------------------|------|-----------|-----|----------------------------|------|------------|-------|
|   | 2008                         |      | 2007      |     | 2008                       |      | 2007       |       |
| Statements of Operations                  |                              |      |           |     |                            |      |            |       |
| Data:                                     |                              |      |           |     |                            |      |            |       |
| Revenues:                                 |                              |      |           |     |                            |      |            |       |
| License                                   | \$ 4,807                     | 19%  | \$ 18,882 | 58% | \$ 13,614                  | 25%  | \$ 26,044  | 47%   |
| Service                                   | 19,909                       | 81   | 13,883    | 42  | 40,236                     | 75   | 29,660     | 53    |
| Total revenues                            | 24,716                       | 100  | 32,765    | 100 | 53,850                     | 100  | 55,704     | 100   |
| Cost of revenues:                         |                              |      |           |     |                            |      |            |       |
| License                                   | 283                          | 1    | 583       | 2   | 617                        | 1    | 1,037      | 2     |
| Service                                   | 8,532                        | 35   | 5,622     | 17  | 17,010                     | 32   | 13,088     | 23    |
| Amortization of intangible assets         | 303                          | 1    | 303       | 1   | 606                        | 1    | 606        | 1     |
| Total cost of revenues                    | 9,118                        | 37   | 6,508     | 20  | 18,233                     | 34   | 14,731     | 26    |
| Gross profit                              | 15,598                       | 63   | 26,257    | 80  | 35,617                     | 66   | 40,973     | 74    |
| Operating expenses:                       |                              |      |           |     |                            |      |            |       |
| Sales and marketing                       | 7,400                        | 30   | 8,314     | 25  | 16,303                     | 30   | 15,578     | 28    |
| Research and development                  | 6,381                        | 26   | 7,296     | 23  | 13,106                     | 24   | 13,592     | 24    |
| General and administrative                | 4,019                        | 16   | 5,295     | 16  | 9,022                      | 17   | 10,906     | 20    |
| Restructuring expense                     | —                            | —    | 255       | 1   | —                          | —    | 6,727      | 12    |
| Total operating expenses                  | 17,800                       | 72   | 21,160    | 65  | 38,431                     | 71   | 46,803     | 84    |
| Income (loss) from operations             |                              |      |           |     |                            |      |            |       |
|   | 2,202                        | (9)  | 5,097     | 15  | (2,814)                    | (5)  | (5,830)    | (10)  |
| Interest income, net                      | 613                          | 3    | 492       | 2   | 1,448                      | 2    | 796        | 2     |
| Other income, net                         | 350                          | 1    | 180       | —   | 485                        | 1    | 165        | —     |
| Income (loss) before income taxes         |                              |      |           |     |                            |      |            |       |
|   | (1,239)                      | (5)  | 5,769     | 17  | (881)                      | (2)  | (4,869)    | (8)   |
| Provision for (benefit from) income taxes |                              |      |           |     |                            |      |            |       |
|   | (80)                         | —    | 794       | 2   | 73                         | —    | 905        | 2     |
| Net income (loss)                         | \$ (1,159)                   | (5)% | \$ 4,975  | 15% | \$ (954)                   | (2)% | \$ (5,774) | (10)% |

## Comparison of the Three and Six Months Ended March 31, 2008 and 2007 (Unaudited)

## Revenues

Total revenues decreased \$8.0 million, or 25%, to \$24.7 million for the three months ended March 31, 2008 compared to \$32.8 million for the three months ended March 31, 2007. This decrease was primarily due to a \$14.1 million or 75% decrease in license revenue offset by an increase of \$6.0 million or 43% in service revenue. Total revenues decreased \$1.9 million, or 3%, to \$53.8 million for the six months ended March 31, 2008 compared to \$55.7 million for the six months ended March 31, 2007. This decrease was primarily due to \$12.4 million or 48% decrease in license revenue offset by an increase of \$10.5 million or 36% in service revenue.

The following summarizes the components of our total revenues:

#### License Revenue

The increase or decrease of license revenue occurring within the three different product emphases is dependent on the timing of when a sales transaction is completed and whether a license transaction was sold with essential consulting services. License revenue sold with essential consulting services is recognized under percentage-of-completion method of accounting. The timing and amount of revenue for those transactions being recognized under the percentage-of-completion is influenced by progress of work performed relative to the project length of customer contracts and the dollar value of such contracts. These orders typically involve consulting services that are essential to functionality of the respective licenses. The following table sets forth our license revenue by product emphasis for the three and six months ended March 31, 2008 and 2007 (in thousands, except percentages):

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|                               | Three Months Ended March 31, |           |             |       | Six Months Ended March 31, |           |             |       |
|-------------------------------|------------------------------|-----------|-------------|-------|----------------------------|-----------|-------------|-------|
|                               | 2008                         | 2007      | Change      | %     | 2008                       | 2007      | Change      | %     |
| License Revenue:              |                              |           |             |       |                            |           |             |       |
| Enterprise solutions          | \$ 3,870                     | \$ 12,619 | \$ (8,749)  | (69)% | \$ 10,084                  | \$ 16,164 | \$ (6,080)  | (38)% |
| Marketing solutions           | 579                          | 1,268     | (689)       | (54)  | 1,293                      | 2,257     | (964)       | (43)  |
| Decision management solutions | 358                          | 4,995     | (4,637)     | (93)  | 2,237                      | 7,623     | (5,386)     | (71)  |
| Total license revenue         | \$ 4,807                     | \$ 18,882 | \$ (14,075) | (75)% | \$ 13,614                  | \$ 26,044 | \$ (12,430) | (48)% |

Total license revenue decreased by \$14.1 million or 75% and \$12.4 million or 48% for the three and six months ended March 31, 2008, respectively, as compared to the same comparable periods in the prior year. The decrease in license revenue is the result of fewer sales transactions and transactions of smaller magnitude being executed in the comparative periods.

## Service Revenue

Service revenue is primarily composed of consulting implementation and integration, consulting customization, training, PCS, and certain reimbursable out-of-pocket expenses. The increase or decrease of service revenue within the three different product emphases is primarily due to the timing of when license transactions are completed, whether or not the license was sold with essential consulting services, the sophistication of the customer's application, and the expertise of the customer's internal development team. For non-essential service transactions, service revenue will lag in timing compared to the period of when the license revenue is recognized. The following table sets forth our service revenue by product emphasis for the three and six months ended March 31, 2008 and 2007 (in thousands, except percentages):

|                               | Three Months Ended March 31, |           |          |     | Six Months Ended March 31, |           |           |     |
|-------------------------------|------------------------------|-----------|----------|-----|----------------------------|-----------|-----------|-----|
|                               | 2008                         | 2007      | Change   | %   | 2008                       | 2007      | Change    | %   |
| Service Revenue:              |                              |           |          |     |                            |           |           |     |
| Enterprise solutions          | \$ 13,439                    | \$ 10,147 | \$ 3,292 | 32% | \$ 28,649                  | \$ 22,346 | \$ 6,303  | 28% |
| Marketing solutions           | 3,070                        | 2,903     | 167      | 6   | 6,188                      | 5,508     | 680       | 12  |
| Decision management solutions | 3,400                        | 833       | 2,567    | 308 | 5,399                      | 1,806     | 3,593     | 199 |
| Total service revenue         | \$ 19,909                    | \$ 13,883 | \$ 6,026 | 43% | \$ 40,236                  | \$ 29,660 | \$ 10,576 | 36% |

Total service revenue increased \$6.0 million or 43% for the three months ended March 31, 2007 as compared to the three months ended March 31, 2008. This change is primarily related to increases of \$2.6 million in consulting revenue, \$2.1 million in support and maintenance revenue, \$0.6 million in training revenue and \$0.7 million in reimbursement of out-of-pocket expense revenue.

Total service revenue increased \$10.6 million or 36% from the six months ended March 31, 2007 to the six months ended March 31, 2008. This change is primarily related to increases of \$5.1 million in support and maintenance revenue, \$3.8 million in consulting revenue, \$0.9 million in training revenue and \$0.8 million of reimbursement of

out-of-pocket expense revenue.

#### Cost of Revenue

##### License

Cost of license revenue includes third-party software royalties and amortization of capitalized software development costs. Royalty expenses can vary depending upon the mix of products sold within the period. In addition, not all license products have associated royalty expense. The capitalized software development costs pertain to a banking product that was completed and available for general release in August 2005 and the third party costs associated with porting of existing products to new platforms. One of the porting projects was completed in August 2007 and the aggregate costs capitalized were \$0.5 million. Amortization expense for the banking product for the three and six months ended March 31, 2008 were \$0.2 million and \$0.5 million, respectively. Amortization expense for the porting project for the three and six months ended March 31, 2008 was less than \$0.1 million in each period. Amortization costs for the banking product are expected to continue through 2008 and amortization costs of the porting project are expected through 2010. The following table sets forth our cost of license revenues for the three and six months ended March 31, 2008 and 2007 (in thousands, except percentages):

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|                             | Three Months Ended March 31, |        |          |       | Six Months Ended March 31, |          |          |       |
|-----------------------------|------------------------------|--------|----------|-------|----------------------------|----------|----------|-------|
|                             | 2008                         | 2007   | Change   | %     | 2008                       | 2007     | Change   | %     |
| Cost of license revenue     | \$ 283                       | \$ 583 | \$ (300) | (52)% | \$ 617                     | \$ 1,037 | \$ (420) | (41)% |
| Percentage of total revenue | 1%                           | 2%     |          |       | 1%                         | 2%       |          |       |

The cost of license revenue decreased by \$0.3 million or 52% from the three months ended March 31, 2007 to the three months ended March 31, 2008. This change is primarily due to the reduction in royalty expense resulting from a 75% decrease in license revenue.

The cost of license revenue decreased \$0.4 million or 41% for the six months ended March 31, 2007 to the six months ended March 31, 2008. This change is primarily due to the reduction in royalty expense resulting from a 48% decrease in license revenue.

## Service

Cost of service revenue consists primarily of personnel costs, third-party consulting costs, facility and travel costs incurred to provide consulting implementation and integration, consulting customization, training, and PCS support services. The following table sets forth our cost of service revenue for the three and six months ended March 31, 2008 and 2007 (in thousands, except percentages):

|                             | Three Months Ended March 31, |          |          |     | Six Months Ended March 31, |           |          |     |
|-----------------------------|------------------------------|----------|----------|-----|----------------------------|-----------|----------|-----|
|                             | 2008                         | 2007     | Change   | %   | 2008                       | 2007      | Change   | %   |
| Cost of service revenue     | \$ 8,532                     | \$ 5,622 | \$ 2,910 | 52% | \$ 17,010                  | \$ 13,088 | \$ 3,922 | 30% |
| Percentage of total revenue | 35%                          | 17%      |          |     | 32%                        | 23%       |          |     |

Cost of service revenue increased by \$2.9 million or 52% from the three months ended March 31, 2007 to the three months ended March 31, 2008. This change is primarily due to a deferral of consulting costs in the prior year period of \$1.1 million associated with an undelivered license element, a \$1.3 million increase in third party consulting costs and a \$0.5 million increase in travel expense.

Cost of service revenue increased by \$3.9 million or 30% from the six months ended March 31, 2007 to the six months ended March 31, 2008. This change is primarily due to a deferral of consulting costs in the prior year period of \$1.2 million associated with an undelivered license element, a \$2.4 million increase in third party consulting costs, a \$0.5 million increase in travel expense offset by a \$0.1 million decrease in facility costs.

## Amortization of Intangible Assets

Amortization of intangible assets cost consists primarily of the amortization of amounts paid for developed technologies, customer lists and tradenames resulting from business acquisitions. The following table sets forth our costs associated with amortization of intangible assets for the three and six months ended March 31, 2008 and 2007 (in thousands, except percentages):

|  | Three Months Ended March 31, |      |        |   | Six Months Ended March 31, |      |        |   |
|--|------------------------------|------|--------|---|----------------------------|------|--------|---|
|  | 2008                         | 2007 | Change | % | 2008                       | 2007 | Change | % |

|                                   |        |        |      |    |        |        |      |    |
|-----------------------------------|--------|--------|------|----|--------|--------|------|----|
| Amortization of intangible assets | \$ 303 | \$ 303 | \$ — | —% | \$ 606 | \$ 606 | \$ — | —% |
| Percentage of total revenue       | 1%     | 1%     |      |    | 1%     | 1%     |      |    |

We expect amortization expense for intangible assets to be \$0.3 million for each of the two remaining quarters in fiscal year 2008, \$1.2 million in fiscal year 2009 and \$0.3 million in fiscal year 2010.

## Operating Expenses

### Sales and Marketing

Sales and marketing expense is composed primarily of costs associated with selling, promoting and advertising our products, product demonstrations and customer sales calls. These costs consist primarily of employee salaries, commissions and bonuses, benefits, facilities, travel expenses and promotional and advertising expenses. The following table sets forth our sales and marketing expenses for the three and six months ended March 31, 2008 and 2007 (in thousands, except percentages):

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|                             | Three Months Ended March 31, |          |          |       | Six Months Ended March 31, |           |        |    |
|-----------------------------|------------------------------|----------|----------|-------|----------------------------|-----------|--------|----|
|                             | 2008                         | 2007     | Change   | %     | 2008                       | 2007      | Change | %  |
| Sales and marketing expense | \$ 7,400                     | \$ 8,314 | \$ (914) | (11)% | \$ 16,303                  | \$ 15,578 | \$ 725 | 5% |
| Percentage of total revenue | 30%                          | 25%      |          |       | 30%                        | 28%       |        |    |

Sales and marketing expense decreased by \$0.9 million or 11% from the three months ended March 31, 2007 to the three months ended March 31, 2008. This change is primarily due to a decrease of \$1.0 million in employee costs driven mainly by a decrease in sales commission expense, a decrease in sales and marketing events of \$0.8 million offset by increases of \$0.6 million of consultant costs, \$0.1 million of travel costs and \$0.1 million of facility costs. In the prior year, the sales and marketing program costs for sales kickoff and presidents club occurred in the March 31, 2007 quarter while in the current year, these programs occurred in the December 31, 2007 quarter.

Sales and marketing expense increased by \$0.7 million or 5% from the six months ended March 31, 2007 to the six months ended March 31, 2008. This change is primarily due to a decrease of \$0.6 million in employee costs driven mainly by a decrease in commission expense, offset by increases of \$0.8 million in consultant costs, \$0.2 million in recruiting and \$0.2 million in sales and marketing program costs.

## Research and Development

Research and development expense is composed primarily of costs associated with the development of new products, enhancements of existing products and quality assurance activities. These costs consist primarily of employee compensation, benefits, facilities, the cost of software and development tools, equipment and consulting costs, including costs for offshore consultants. The following table sets forth our research and development expenses for the three and six months ended March 31, 2008 and 2007 (in thousands, except percentages):

|                                  | Three Months Ended March 31, |          |          |       | Six Months Ended March 31, |           |          |      |
|----------------------------------|------------------------------|----------|----------|-------|----------------------------|-----------|----------|------|
|                                  | 2008                         | 2007     | Change   | %     | 2008                       | 2007      | Change   | %    |
| Research and development expense | \$ 6,381                     | \$ 7,296 | \$ (915) | (13)% | \$ 13,106                  | \$ 13,592 | \$ (486) | (4)% |
| Percentage of total revenue      | 26%                          | 23%      |          |       | 24%                        | 24%       |          |      |

Research and development expense decreased by \$0.9 million or 13% from the three months ended March 31, 2007 to the three months ended March 31, 2008. This decrease is primarily due to a \$0.8 million reduction in employee costs related to executive and employee bonuses not being earned for the quarter. In addition, travel and entertainment expenses decreased \$0.1 million in the March 31, 2008 quarter.

Research and development expense decreased by \$0.5 million or 4% from the six months ended March 31, 2007 to the six months ended March 31, 2008. This decrease is primarily due to a \$0.3 million reduction in employee costs related to executive and employee bonuses not being earned for the second quarter of the year ending March 31, 2008. In addition, travel and entertainment expenses decreased \$0.2 million for the period.

## General and Administrative

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General and administrative expense is composed primarily of costs associated with our executive and administrative personnel (e.g. the CEO, legal, human resources and finance personnel). These costs consist primarily of employee compensation, bonuses, stock compensation expense, benefits, facilities, consulting, legal and audit costs, including costs for Sarbanes-Oxley Act of 2002 (SOX) compliance. The following table sets forth our general and administrative expenses for the three and six months ended March 31, 2007 and 2008 (in thousands, except percentages):

|                                    | Three Months Ended March 31, |          |            |       | Six Months Ended March 31, |           |            |       |
|------------------------------------|------------------------------|----------|------------|-------|----------------------------|-----------|------------|-------|
|                                    | 2008                         | 2007     | Change     | %     | 2008                       | 2007      | Change     | %     |
| General and administrative expense | \$ 4,019                     | \$ 5,295 | \$ (1,276) | (24)% | \$ 9,022                   | \$ 10,906 | \$ (1,884) | (17)% |
| Percentage of total revenue        | 16%                          | 16%      |            |       | 17%                        | 20%       |            |       |

General and administrative expense decreased by \$1.3 million or 24% from the three months ended March 31, 2007 to the three months ended March 31, 2008. This change is primarily due to decreases of \$0.6 million in professional services associated with the stock option investigation in prior year, \$0.5 million in executive and employee bonuses not being earned in the current quarter and \$0.2 million in travel expenses.

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General and administrative expense decreased by \$1.9 million or 17% from the six months ended March 31, 2007 to the six months ended March 31, 2008. This change is primarily due to decreases of \$1.3 million in professional services associated with the stock option investigation in prior year and \$0.6 million of executive and employee bonuses not being earned in the second current quarter of the year ending March 31, 2008.

**Restructuring Expense**

In October 2006, we initiated a restructuring plan that included an immediate reduction in positions of slightly more than ten percent of the Company's workforce, consolidation of our European facilities, and the closure of our French office. A majority of the positions eliminated were in Europe.

At December 31, 2006, we recorded a pre-tax cash restructuring charge of \$6.5 million as calculated using the net present value of the related costs as required by SFAS 146. The charge was composed of \$1.7 million for severance costs and \$4.8 million for exiting excess facilities. The facilities are subject to operating leases expiring through 2010. The Company anticipated that approximately \$5.4 million of the charge would result in cash expenditures.

During the quarter ended March 31, 2007, the Company incurred an additional charge of \$0.1 million for employee severance costs associated with the closure of the France office. Also during March 2007, the Company negotiated an early termination of the France office lease associated with its closure resulting in a \$0.2 million reduction in the restructure facility liability. This reduction was recorded as an offset to restructuring expense in the period.

Prior Restructuring. During fiscal year 2002, we restructured several areas of the Company to reduce expenses and improve revenues. As part of this restructuring, we closed an office facility in Boston, Massachusetts and recorded a charge associated with the long term lease which expires in January 2011. In the March 2007 quarter, we completed a new sublease with a sub-lessee for the remaining term of our lease at a rate lower than that which was forecasted when the original restructure charge was recorded in 2002. This change in estimate resulted in a \$0.3 million charge to restructuring in the quarter ended March 31, 2007.

**Stock-Based Compensation (Included in Individual Operating Expense and Cost of Revenue Categories)**

The following table sets forth our stock-based compensation expense and functional breakdown for the three and six months ended March 31, 2008 and 2007 (in thousands):

|  | Three Months Ended March 31, |        | Six Months Ended March 31, |          |
|--|------------------------------|--------|----------------------------|----------|
|  | 2008                         | 2007   | 2008                       | 2007     |
| Cost of revenues – service             | \$ 109                       | \$ 54  | \$ 262                     | \$ 161   |
| Operating expenses:                    |                              |        |                            |          |
| Sales and marketing                    | 230                          | 237    | 471                        | 566      |
| Research and development               | 144                          | 168    | 343                        | 262      |
| General and administrative             | 498                          | 434    | 1,081                      | 880      |
| Total operating expense                | 872                          | 839    | 1,895                      | 1,708    |
| Total stock-based compensation expense | \$ 981                       | \$ 893 | \$ 2,157                   | \$ 1,869 |

For the three months ended March 31, 2008, the aggregate stock-based compensation cost included in cost of revenues and in operating expenses was \$1.0 million that is primarily related to \$1.0 million associated with employee stock options, \$0.1 million associated with restricted stock awards and a decrease of \$0.1 million for restricted stock units.

For the three months ended March 31, 2007, the aggregate stock-based compensation cost included in cost of revenues and in operating expenses was \$0.9 million that is primarily related to \$0.8 million associated with employee stock options and \$0.1 million associated with restricted stock awards.

For the six months ended March 31, 2008, the aggregate stock-based compensation cost included in cost of revenues and in operating expenses was \$2.2 million that is primarily related to \$1.9 million associated with employee stock options, less than \$0.1 million associated with restricted stock awards and \$0.2 million for restricted stock units. For the six months ended March 31, 2007, the aggregate stock-based compensation cost included in cost of revenues and in operating expenses was \$1.9 million that is primarily related to \$1.5 million associated with employee stock options and \$0.4 million associated with restricted stock awards.

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## Interest Income, Net

Interest income, net, consists primarily of interest income generated from our cash, cash equivalents, and marketable securities offset by interest expense incurred in connection with capital equipment leases and imputed under SFAS 146 restructuring accruals. The following table sets forth our interest income, net for the three and six months ended March 31, 2008 and 2007 (in thousands, except percentages):

|                             | Three Months Ended March 31, |        |        |     | Six Months Ended March 31, |        |        |     |
|-----------------------------|------------------------------|--------|--------|-----|----------------------------|--------|--------|-----|
|                             | 2008                         | 2007   | Change | %   | 2008                       | 2007   | Change | %   |
| Interest income, net        | \$ 613                       | \$ 492 | \$ 121 | 25% | \$ 1,448                   | \$ 796 | \$ 652 | 82% |
| Percentage of total revenue | 3%                           | 2%     |        |     | 2%                         | 2%     |        |     |

Interest income, net increased by 25% and 82% from the three and six months ended March 31, 2007 to the three and six months ended March 31, 2008, respectively, primarily due to the Company transferring a portion of its funds into marketable securities which earn a higher return of interest income than other investments we utilized in the prior year and higher average cash balances in the current year than in the prior year. We anticipate lower interest income in the near term due to the use of up to \$25 million for the stock repurchase program.

## Other Income, Net

These gains and losses are primarily associated with foreign currency transaction gains or losses and the re-measurement of our short-term intercompany balances between the U.S. and our foreign currency denominated subsidiaries. The following table sets forth our other income (expense), net for the three and six months ended March 31, 2008 and 2007 (in thousands, except percentages):

|                             | Three Months Ended March 31, |        |        |     | Six Months Ended March 31, |        |        |      |
|-----------------------------|------------------------------|--------|--------|-----|----------------------------|--------|--------|------|
|                             | 2008                         | 2007   | Change | %   | 2008                       | 2007   | Change | %    |
| Other income, net           | \$ 350                       | \$ 180 | \$ 170 | 94% | \$ 485                     | \$ 165 | \$ 320 | 194% |
| Percentage of total revenue | 1%                           | —%     |        |     | 1%                         | —%     |        |      |

Other income increased by 94% and 194% from the three and six months ended March 31, 2007 to the three and six months ended March 31, 2008, respectively. This increase is primarily due to higher transaction gains associated with our foreign intercompany balances.

## Provision for (Benefit from) Income Taxes

These provisions (benefits) are primarily attributable to taxes on earnings from our foreign subsidiaries, certain foreign withholding taxes, and the alternate minimum tax for federal taxes. The following table sets forth our provision for (benefit from) income taxes for the three and six months ended March 31, 2008 and 2007 (in thousands, except percentages):

|                                      | Three Months Ended March 31, |        |          |        | Six Months Ended March 31, |        |          |       |
|--------------------------------------|------------------------------|--------|----------|--------|----------------------------|--------|----------|-------|
|                                      | 2008                         | 2007   | Change   | %      | 2008                       | 2007   | Change   | %     |
| Provision (benefit) for income taxes | \$ (80)                      | \$ 794 | \$ (874) | (110)% | \$ 73                      | \$ 905 | \$ (832) | (92)% |
|                                      | —%                           | 2%     |          |        | —%                         | 2%     |          |       |

Percentage of total  
revenue

The provision for income taxes decreased 110% and 92% for the three and six months ended March 31, 2008, respectively, as compared to the same periods of the prior year. This decrease year-to-year and quarter-to-quarter is primarily due to a \$0.5 million withholding tax payment related to a sales transaction that occurred in Turkey during the March 2007 quarter.

Our deferred tax assets primarily consist of net operating loss carryforwards, nondeductible allowances and research and development tax credits. We have recorded a valuation allowance for the full amount of our net deferred tax assets, as the future realization of the tax benefit is not considered by management to be more-likely-than-not.

Liquidity and Capital Resources

For the three and six months ended March 31, 2008, we have not been profitable and have not generated a net increase in cash and cash equivalents. We expect our current cash and cash equivalent balances to be in excess of cash requirements for the next twelve months.



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### Operating Activities

Cash used for operating activities was \$12.6 million during the six months ended March 31, 2008, which consisted primarily of our net loss of \$1.0 million adjusted for non-cash items (primarily depreciation and amortization, non-cash stock-based compensation expense, provision for doubtful accounts and other non-cash charges) aggregating approximately \$4.3 million and the net cash outflow effect from changes in assets and liabilities of approximately \$15.9 million. This net cash outflow was primarily related to decreases in deferred revenue of \$13.4 million, accrued expenses of \$4.1 million and prepaid expenses of \$2.0 million offset by increases in accounts receivable of \$1.9 million and accounts payable of \$1.1 million.

Cash provided by operating activities was \$23.5 million during the six months ended March 31, 2007, which consisted primarily of our net loss of \$5.8 million adjusted for non-cash items (primarily depreciation, amortization, provision for doubtful accounts, loss on disposal of assets, other non-cash charges and non-cash stock-based compensation expense) aggregating approximately \$4.8 million and the net cash inflow effect from changes in assets and liabilities of approximately \$24.4 million. This net cash inflow was primarily related to increases in deferred revenue of \$34.9 million and accrued expenses of \$3.0 million offset by reductions in accounts receivable of \$9.3 million and prepaid expenses of \$4.4 million. The increase in deferred revenue is the result of sales transactions that were completed during the six month period ended March 31, 2007 for which revenue is not recognized until subsequent periods.

### Investing Activities

Cash provided by investing activities was \$10.4 million during the six months ended March 31, 2008. This cash provided was primarily from \$11.5 million of net proceeds from marketable securities offset by the use of cash for the purchase of \$1.0 million of property and equipment and the capitalization of \$0.1 million of software development costs associated with the porting of existing products to a new platform.

Cash used for investing activities was \$1.3 million during the six months ended March 31, 2007. This use of cash was primarily for purchases of property and equipment associated with the closure of the old European headquarters office and the opening of the new smaller European headquarters office during the period.

### Financing Activities

Cash used by financing activities was \$7.5 million during the six months ended March 31, 2008. This use of cash was primarily related to the repurchase of \$8.1 million of common stock under our stock repurchase program offset by proceeds from stock option exercises of \$0.6 million. We expect to continue using cash for financing activities in connection with our stock repurchase program.

Cash provided by financing activities was \$3.1 million during the six months ended March 31, 2007. This cash provided was primarily related to proceeds from stock option exercises of \$3.2 million.

### Revolving Line of Credit

See Note 8 to the Condensed Consolidated Financial Statements for detailed information regarding our revolving line of credit.

### Contractual Obligations

Ness

We entered into an agreement with Ness Technologies Inc., Ness Global Services, Inc. and Ness Technologies India, Ltd. (collectively, “Ness”), effective December 15, 2003, pursuant to which Ness provides our customers with technical product support through a worldwide help desk facility, a sustaining engineering function that serves as the interface between technical product support and our internal engineering organization, product testing services and product development services (collectively, the “Services”). The agreement had an initial term of three years and was extended for two additional one year terms. Under the terms of the agreement, we pay for services rendered on a monthly fee basis, including the requirement to reimburse Ness for approved out-of-pocket expenses. The agreement may be terminated for convenience by us, subject to the payment of a termination fee. In 2004, 2005, 2006 and 2007 we further expanded our agreement with Ness whereby Ness is providing certain additional technical and consulting services. The additional agreements can be cancelled at the option of us without the payment of a termination fee. The remaining minimum purchase commitment under these agreements, if Chordiant was to cancel the contracts, was approximately \$0.7 million at March 31, 2008. In addition to service agreements, we also guaranteed certain equipment lease obligations of Ness (see Note 9 to the Condensed Consolidated Financial Statements). Ness may procure equipment to be used in performance of the Services, either through leasing arrangements or direct cash purchases, for which we are obligated under the agreement to reimburse them. In connection with the procurement of equipment, Ness has

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entered into a 36 month equipment lease agreement with IBM India and, in connection with the lease agreement we have an outstanding standby letter of credit in the amount of \$0.2 million in guarantee of Ness' financial commitments under the lease. Over the term of the lease, our obligation to reimburse Ness is approximately equal to the amount of the guarantee.

## Leases

Operating lease obligations in the table below include approximately \$1.9 million for our Boston, Massachusetts facility operating lease commitments that are included in Restructuring expenses. As of March 31, 2008, the Company has \$0.8 million in sublease income contractually committed for future periods relating to this facility. See Notes 5 and 9 to the Condensed Consolidated Financial Statements for further discussion.

The office lease for our Cupertino headquarters expires on December 31, 2008. In April 2008, we have exercised an option to renew our lease for an additional five years at ninety-five percent of the fair market value on December 31, 2008. While market rates can not be determined at this time, we expect our operating lease expense for this facility to increase effective January 1, 2009.

We have asset retirement obligations, associated with commitments to return property subject to operating leases to original condition upon lease termination. As of March 31, 2008, we estimate that gross expected cash flows of approximately \$0.4 million will be required to fulfill these obligations

We have no material commitments for capital expenditures and do not anticipate capital expenditures to fluctuate significantly from historic levels.

The following table presents certain payments due under contractual obligations as of March 31, 2008 based on fiscal years (in thousands):

|                              | Total     | Payments Due By Period |                     |                     |            |
|------------------------------|-----------|------------------------|---------------------|---------------------|------------|
|                              |           | Due in<br>2008         | Due in<br>2009-2010 | Due in<br>2011-2012 | Thereafter |
| Operating lease obligations  | \$ 9,930  | \$ 1,610               | \$ 4,963            | \$ 2,697            | \$ 660     |
| Asset retirement obligations | 365       | —                      | —                   | 365                 | —          |
| Total                        | \$ 10,295 | \$ 1,610               | \$ 4,963            | \$ 3,062            | \$ 660     |

Effective October 1, 2007, the Company adopted FIN No. 48 and reclassified \$0.2 million of gross unrecognized tax benefits to Other Long-Term Liabilities in our Condensed Consolidated Balance Sheets. As of March 31, 2008, the Company cannot make a reasonably reliable estimate of the period in which these liabilities may be settled with the respective tax authorities. See Note 11 to the Condensed Consolidated Financial Statements for additional information.

We believe that the effects of our strategic actions implemented to improve revenue as well as to control costs will be adequate to generate sufficient cash flows from operations, which, when combined with existing cash balances, we anticipate will be sufficient to meet our working capital and operating resource expenditure requirements for the near term. If the global economy weakens, additional declines in cash balances could occur.

We anticipate that operating expenses will continue to be a material use of our cash resources. We may continue to utilize cash resources to fund acquisitions or investments in other businesses, technologies or product lines. In the long-term, we may require additional funds to support our working capital and operating expense requirements or for other purposes, and may seek to raise these additional funds through public or private debt or equity financings. There

can be no assurance that this additional financing will be available, or if available, will be on reasonable terms. Failure to generate sufficient revenues or to control spending could adversely affect our ability to achieve our business objectives.

#### Indemnification

See Note 9 to the Condensed Consolidated Financial Statements for detailed information regarding our indemnifications.

#### Off Balance Sheet Arrangements

None.

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

We are exposed to the impact of interest rate changes and foreign currency fluctuations.

The following table presents the amounts of restricted cash and marketable securities that are subject to interest rate risk and average interest rates as of March 31, 2008 (in thousands):

|  | March 31,<br>2008 | Fair Value | Average<br>Interest<br>Rates |
|--|-------------------|------------|------------------------------|
| Restricted cash invested in short-term investments | \$ 323            | \$ 323     | 2.7%                         |
| Marketable securities                              | 751               | 751        | 5.5%                         |
| Total restricted cash and marketable securities    | \$ 1,074          | \$ 1,074   | 4.7%                         |

The following table presents the amounts of restricted cash that are subject to interest rate risk by year of expected maturity and average interest rates as of March 31, 2007 (in thousands):

|  | March 31,<br>2007 | Fair Value | Average<br>Interest<br>Rates |
|--|-------------------|------------|------------------------------|
| Restricted cash invested in short-term investments | \$ 354            | \$ 354     | 3.0%                         |

**Interest Rate Risk.** Our exposure to market rate risk for changes in interest rates relates primarily to money market accounts, commercial paper, short-term certificates of deposit and marketable securities. We invest our excess cash in money market accounts, commercial paper, certificates-of-deposit, and marketable securities with maturities of less than one year. We do not invest in auction rate securities. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell our fixed rate securities which have declined in market value due to changes in interest rates.

To provide a meaningful assessment of the interest rate risk associated with the Company's total restricted cash and marketable securities, we performed a sensitivity analysis to determine the hypothetical impact of a decrease in interest rate of 100 basis points. Assuming consistent investment levels as of March 31, 2008, interest income would decline by less than \$0.1 million. Assuming consistent investment levels as of March 31, 2007, interest income would have declined by less than \$0.1 million.

**Foreign Currency Risk.** International revenues accounted for approximately 44% and 59% of total revenues for six months ended March 31, 2008 and 2007, respectively. International revenues decreased \$9.4 million or 29% compared to the same period of the prior year. Our international operations have increased our exposure to foreign currency fluctuations. Revenues and related expense generated from our international subsidiaries are generally denominated in the functional currencies of the local countries. Primary currencies include the United Kingdom Pound Sterling, the Euro and the Canadian Dollar. The Condensed Consolidated Statement of Operations is translated into United States Dollars at the average exchange rates in each applicable period. To the extent the United States Dollar strengthens against foreign currencies, the translation of these foreign currencies denominated transactions

results in reduced revenues, operating expense, and net income for our international operations. Similarly, our revenues, operating expenses, and net income will increase for our international operations if the United States Dollar weakens against foreign currencies. Using the average foreign currency exchange rates for the six months ended March 31, 2008, our international revenues for the six months ended March 31, 2008 would have been lower than we reported by approximately \$0.3 million and our international loss from operations would have been greater than we reported by \$0.1 million. Using the average foreign currency exchange rates for the six months ended March 31, 2007, our international revenues for the six months ended March 31, 2008 would have been lower than we reported by approximately \$1.9 million and our international loss from operations would have been greater than we reported by \$0.2 million.

We are also exposed to foreign exchange rate fluctuations as we convert the financial statements of our foreign subsidiaries and our investments in equity interests into United States dollars in consolidation. If there is a change in foreign currency exchange rates, the conversion of the foreign subsidiaries' financial statements into United States dollars will lead to a translation gain or loss which is recorded as a component of accumulated other comprehensive income which is a component of Stockholders' Equity. In addition, we have certain assets and liabilities that are denominated in currencies other than the relevant entity's functional currency. Changes in the functional currency value of these assets and liabilities create fluctuations that will lead to a transaction gain or loss. For the six months ended March 31, 2008 and 2007, we recorded net foreign currency transaction gains of \$0.4 million and \$0.2 million, respectively, which was recorded in "Other income, net," in the Condensed Consolidated Statements of Operations.

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Item 4. Controls and Procedures.

Under the supervision and with the participation of our management, including the President and Chief Executive Officer and the Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act of 1934, as amended, Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended March 31, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings

See Note 10 to the Condensed Consolidated Financial Statements in Part 1, Item 1 of this Form 10-Q for a description of our legal proceedings.

Item 1A. Risk Factors

The Company has marked with an asterisk (\*) those risk factors that reflect substantive changes from the risk factors included in the Company's Form 10-K filed with the Securities and Exchange Commission for the fiscal year ended September 30, 2007.

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

Sales of our products and services in five large markets—banking, insurance, healthcare, telecommunications and retail markets accounted for approximately 98% and 99% of our total revenues for the six months ended March 31, 2008 and 2007, respectively. We expect that revenues from these five markets will continue to account for a substantial portion of our total revenues for the foreseeable future. However, we are seeking to expand in other markets. If we are unable to successfully increase penetration of our existing markets or achieve sales in additional markets, or if the overall economic climate of our target markets further deteriorates, our revenues may decline. Some of our current or prospective customers, especially those in the banking and insurance industries are in businesses that have or could have exposure, directly or indirectly, to the residential mortgage sector or homebuilder sector which has recently been facing financial difficulties. This may cause our current or prospective customers to reduce their spending on technology, which in turn would have an adverse impact on our sales and revenues.

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

The period between initial contact with a prospective customer and the implementation of our products is unpredictable and often lengthy, ranging from three to twenty-four months. Thus, revenue and cash receipts could vary significantly from quarter to quarter. Any delays in the implementation of our products could cause reductions in our revenues. The licensing of our products is often an enterprise-wide decision that generally requires us to provide a significant level of education to prospective customers about the use and benefits of our products. The implementation of our products involves significant commitment of technical and financial resources and is commonly associated with substantial implementation efforts that may be performed by us, by the customer or by third-party systems integrators. If we underestimate the resources required to meet the expectations we have set with a customer when we set prices, then we may experience a net loss on that customer engagement. If this happens with a large customer engagement, then this could have a material adverse effect on our financial results. Customers generally consider a wide range of issues before committing to purchase our products, including product benefits, ability to operate with existing and future computer systems, vendor financial stability and longevity, ability to accommodate increased transaction volume and product reliability. Certain of our customers have become more cautious regarding their IT purchases given the overall economy and specifically the issues that continue to impact the financial markets. The result of this attitude is that our sales cycles have lengthened in some instances, requiring more time to finalize transactions. In particular, several transactions we expected to close before the end of the quarter ended March 31, 2008 were delayed.



The matters relating to the Audit Committee of the Board's review of our historical stock option granting practices and the restatement of our Consolidated Financial Statements have resulted in litigation, and may result in additional litigation.

On July 24, 2006, the Company announced that the Audit Committee of the Company's Board of Directors, with the assistance of independent legal counsel, would conduct a review of our stock option practices covering the time from the Company's initial public offering in 2000 through June 2006. As described in Note 3 "Restatement of Previously Issued Consolidated Financial Statements" in Notes to Consolidated Financial Statements in the 2006 Form 10-K, the Audit Committee reached a conclusion that incorrect measurement dates were used for financial accounting purposes for stock option grants in certain prior periods. As a result, the Company has recorded additional non-cash stock-based compensation expense, and related tax effects, related to certain stock option grants, and the Company has restated certain previously filed financial statements included in the 2006 Annual Report on Form 10-K.

This review of our historical stock option granting practices has required us to incur substantial expenses for legal, accounting, tax and other professional services, has diverted our management's attention from our business, and any litigation or future government enforcement actions could in the future adversely affect our business, financial condition, results of operations and cash flows.

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Our historical stock option granting practices and the restatement of our prior financial statements have exposed us to greater risks associated with litigation proceedings. Several derivative complaints have been filed pertaining to allegations relating to stock option grants. We cannot assure you that these or future similar complaints or any future litigation or regulatory action will result in the same conclusions reached by the Audit Committee. The conduct and resolution of these matters will be time consuming, expensive and distracting from the conduct of our business.

We contacted the SEC regarding the Audit Committee's review and, in July 2006, the SEC commenced an investigation into our historical stock option grant practices. In November 2006, a representative of the Audit Committee and its informal advisors met with the enforcement staff of the SEC and provided them with a report of the Audit Committee's investigation and findings. In January 2007, the enforcement staff of the SEC notified the Company that its investigation had been terminated and no enforcement action had been recommended to the Commission.

The findings of the Audit Committee's review are more fully described in Note 3 to the Consolidated Financial Statements and in Item 9A of the Annual Report on Form 10-K for the year ended September 30, 2006.

\* We were not profitable for the six months ended March 31, 2008 and we may continue to incur losses in the future, which may raise vendor viability concerns thereby making it more difficult to close license transactions with new and existing customers.

We incurred losses of \$1.0 million and \$5.8 million for the six months ended March 31, 2008 and 2007, respectively. As of March 31, 2008, we had an accumulated deficit of \$227.9 million. We may continue to incur losses and cannot be certain that we can generate sufficient revenues to achieve profitability. Continued losses may leave many customers reluctant to enter into new large value license transactions without some assurance that we will operate profitably. If we fail to enter into new large value license transactions due to vendor profitability and/or viability concerns, our revenues will decline, which could further adversely affect our operating results.

\* Because a small number of customers account for a substantial portion of our revenues, the loss of a significant customer could cause a substantial decline in our revenues.

We derive a significant portion of our license and service revenue from a limited number of customers. The loss of a major customer could cause a decrease in revenues and net income. For the three months ended March 31, 2008, Citicorp Credit Services, Inc. and Wellpoint, Inc. accounted for 25% and 11% of our total revenue. For the six months ended March 31, 2008, Citicorp Credit Services, Inc., Wellpoint, Inc. and IBM accounted for 23%, 11% and 10% of our total revenue, respectively. While our customer concentration has fluctuated, we expect that a limited number of customers will continue to account for a substantial portion of our revenues in any given period. As a result, if we lose a major customer, or if a contract is delayed or cancelled or we do not contract with new major customers, our revenues and net loss would be adversely affected. In addition, customers that have accounted for significant revenues in the past may not generate revenues in any future period, causing our failure to obtain new significant customers or additional orders from existing customers to materially affect our operating results.

\* If we fail to adequately address the difficulties of managing our international operations, our revenues and operating expenses will be adversely affected.

For the six months ended March 31, 2008, international revenues were \$23.6 million or approximately 44% of our total revenues. For the six months ended March 31, 2007, international revenues were \$33.0 million or approximately 59% of our total revenues. International revenues will continue to represent a significant portion of our total revenues in future periods. We have faced, and will continue to face, difficulties in managing international operations which

include:

- Difficulties in hiring qualified local personnel;
  - Seasonal fluctuations in customer orders;
  - Longer accounts receivable collection cycles;
  - Expenses associated with licensing products and servicing customers in foreign markets;
  - Economic downturns and political uncertainty in international economies;
- Income tax withholding issues in countries in which we do not have a physical presence, resulting in non-recoverable tax payments;

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- Complex transfer pricing arrangements between legal entities;

• Doing business and licensing our software to customers in countries with weaker intellectual property protection laws and enforcement capabilities;

• Difficulties in commencing new operations in countries where the Company has not previously conducted business, including those associated with tax laws, employment laws, government regulation, product warranty laws and adopting to local customs and culture; and

Any of these factors could have a significant impact on our ability to license products on a competitive and timely basis and could adversely affect our operating expenses and net income. Additionally we closed our only French office in the first fiscal quarter of 2007. The absence of a business office in France may harm our ability to attract and retain customers in that country.

Our known backlog of business may not result in revenue.

An increasingly material portion of our revenues has been derived from large orders, as major customers deployed our products. We define backlog as contractual commitments by our customers through purchase orders or contracts. Backlog is comprised of software license orders which have not been accepted by customers or have not otherwise met all of the required criteria for revenue recognition, deferred revenue from customer support contracts, and deferred consulting and education orders for services not yet completed or delivered. Backlog is not necessarily indicative of revenues to be recognized in a specified future period. There are many factors that would impact the Company's filling of backlog, such as the Company's progress in completing projects for its customers and Chordiant's customers' meeting anticipated schedules for customer-dependent deliverables. The Company provides no assurances that any portion of its backlog will be filled during any fiscal year or at all or that its backlog will be recognized as revenues in any given period. In addition, it is possible that customers from whom we expect to derive revenue from backlog will default and as a result we may not be able to recognize expected revenue from backlog.

\* Fluctuations in the value of the U.S. dollar relative to foreign currencies could make our products less competitive in international markets and could negatively affect our operating results and cash flows.

A significant portion of our sales and operating expenses result from transactions outside of the U.S., often denominated in foreign currencies. These currencies include the United Kingdom Pound Sterling, the Euro and the Canadian Dollar. Our international sales comprised 44% of our total sales for the six months ended March 31, 2008. Our international sales comprised 59% of our total sales for the six months ended March 31, 2007. Our future operating results will continue to be subject to fluctuations in foreign currency rates, especially if international sales increase as a percentage of our total sales, and we may be negatively impacted by fluctuations in foreign currency rates in the future. For the six months ended March 31, 2008, we had a foreign currency transaction gain of \$0.4 million. See Item 3 Quantitative and Qualitative Disclosures about Market Risk for further discussions.

Geopolitical concerns could make the closing of license transactions with new and existing customers difficult.

Our revenues will decrease in fiscal year 2008 or beyond if we are unable to enter into new large-scale license transactions with new and existing customers. The current state of world affairs and geopolitical concerns have left many customers reluctant to enter into new large value license transactions without some assurance that the economy both in the customer's home country and worldwide will have some economic and political stability. Geopolitical instability will continue to make closing large license transactions difficult. In addition, we cannot predict what effect the U.S. military presence overseas or potential or actual political or military conflict have had or are continuing to

have on our existing and prospective customers' decision-making process with respect to licensing or implementing enterprise-level products such as ours. Our ability to enter into new large license transactions also directly affects our ability to create additional consulting services and maintenance revenues, on which we also depend.

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

Increased competition in our markets could result in price reductions for our products and services, reduced gross margins and loss of market share, any one of which could reduce our future revenues. The market for our products is intensely competitive, evolving and subject to rapid technological change. Historically, our primary competition has been from internal development, custom systems integration projects and application software competitors. In particular, we compete with:

- Internal information technology departments: in-house information technology departments of potential customers have developed or may develop systems that provide some or all of the functionality of our products. We expect that internally developed application integration and process automation efforts will continue to be a significant source of competition.

Custom systems integration projects: we compete with large systems integrators who may develop custom solutions for specific companies which may reduce the likelihood that they would purchase our products and services.

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Point application vendors: we compete with providers of stand-alone point solutions for web-based customer relationship management and traditional client/server-based, call-center service customer and sales-force automation solution providers.

The enterprise software industry continues to undergo consolidation in sectors of the software industry in which we operate. Within 2007 and 2008, IBM acquired Cognos, DataMirror and Watchfire Corporation, Oracle completed its acquisition of Hyperion and Moniforce and has entered into an agreement to purchase BEA Systems, Sun Microsystems has entered in an agreement to purchase MySQL and SAP acquired BusinessObjects, YASU Technologies and Pilot Software. While we do not believe that Cognos, DataMirror, Watchfire Corporation, Hyperion, Moniforce, BEA Systems, MySQL, BusinessObjects, YASU Technologies, or Pilot Software have been significant competitors of Chordiant in the past, the acquisition of these companies by IBM, Oracle, Sun Microsystems and SAP may indicate that we will face increased competition from larger and more established entities in the future.

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

\*The company's common stock price has historically been and may continue be volatile, which could result in substantial losses for stockholders.

The market price of shares of the Company's common stock has been, and is likely to continue to be, highly volatile and may be significantly affected by factors such as the following:

- Actual or anticipated fluctuations in its operating results;
- Changes in economic and political conditions in the United States and abroad;
- Terrorist attacks, war or the threat of terrorist attacks and war;
- The announcement of mergers or acquisitions by the Company or its competitors;
- Financial difficulties or poor operating results announced by significant customers;
  - Developments in ongoing or threatened litigation;
  - Announcements of technological innovations;
- Failure to comply with the requirements of Section 404 of the Sarbanes-Oxley Act;
- New products or new contracts announced by it or its competitors;
- Developments with respect to intellectual property laws;
- Price and volume fluctuations in the stock market;
- Changes in corporate purchasing of software by companies in the industry verticals supported by the Company;

- Adoption of new accounting standards affecting the software industry; and
- Changes in financial estimates by securities analysts.

In addition, following periods of volatility in the market price of a particular company's securities, securities class action litigation has often been brought against such companies. If the Company is involved in such litigation, it could result in substantial costs and a diversion of management's attention and resources and could materially harm the Company's business, operating results and financial condition.

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

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

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- Size and timing of individual license transactions;
- Delay or deferral of customer implementations of our products and subsequent impact on revenues;
- Lengthening of our sales cycle;
- Potential additional deterioration and changes in domestic and foreign markets and economies including those impacted by the difficulties in the sub-prime lending markets;
- Success in expanding our global services organization, direct sales force and indirect distribution channels;
- Timing of new product introductions and product enhancements;
- Appropriate mix of products licensed and services sold;
- Levels of international transactions;
- Activities of and acquisitions by competitors;
- Product and price competition; and
- Our ability to develop and market new products and control costs.

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

\*Our operating results and cash flows fluctuate significantly and delays in delivery or implementation of our products or changes in the payment terms with customers may cause unanticipated declines in revenues or cash flow, which could disappoint investors and result in a decline in our stock price.

A portion of our quarterly revenues depend primarily upon product implementation by our customers. We have historically recognized a significant portion of our license and services revenue through the percentage-of-completion method, using labor hours incurred as the measure of progress towards completion of implementation of our products and we expect this practice to continue. The percentage of completion accounting method requires ongoing estimates of progress of complicated and frequently changing technology projects. Documenting the measure of progress towards completion of implementation is subject to potential errors and changes in estimates. As a result, even minor errors or minor changes in estimates may lead to significant changes in accounting results which may be revised in later quarters due to subsequent information and events. Thus, delays or changes in customer business goals or direction when implementing our software may adversely impact our quarterly revenue. Additionally, we may increasingly enter into term, subscription or transaction based licensing transactions that would cause us to recognize license revenue for such transactions over a longer period of time than we have historically experienced for our perpetual licenses. In addition, a significant portion of new customer orders have been booked in the third month of each calendar quarter, with many of these bookings occurring in the last two weeks of the third month. We expect this trend to continue and, therefore, any failure or delay in bookings would decrease our quarterly revenue and cash flows. The terms and conditions of individual license agreements with customers vary from transaction to transaction.



Historically, the Company has been able to obtain prepayments for product in some cases, but more recently we have entered into large transactions with payments from customers due over one or more years. Other transactions link payment to the delivery or acceptance of products. If we are unable to negotiate prepayments of fees our cash flows and financial ratios with respect to accounts receivable would be adversely impacted. If our revenues, operating margins or cash flows are below the expectations of the investment community, our stock price is likely to decline.

If we fail to maintain and expand our relationships with systems integrators and other business partners, our ability to develop, market, sell, and support our products may be adversely affected.

Our development, marketing and distribution strategies rely on our ability to form and maintain long-term strategic relationships with systems integrators, in particular, our existing business alliance partners, IBM, Accenture and HCL Technologies. These business relationships often consist of joint marketing programs, technology partnerships and resale and distribution arrangements. Although most aspects of these relationships are contractual in nature, many important aspects of these relationships depend on the continued cooperation between the parties. Divergence in strategy, change in focus, competitive product offerings or potential contract defaults may interfere with our ability to develop, market, sell, or support our products, which in turn could harm our business. If either IBM, Accenture, or HCL Technologies were to terminate their agreements with us

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or our relationship were to deteriorate, it could have a material adverse effect on our business, financial condition and results of operations. In many cases, these parties have extensive relationships with our existing and potential customers and influence the decisions of these customers. A number of our competitors have stronger relationships with IBM, Accenture and HCL Technologies and, as a result, these systems integrators may be more likely to recommend competitors' products and services. In 2007 and 2008, IBM acquired Cognos, DataMirror and Watchfire Corporation. While we do not believe that either Cognos, DataMirror or Watchfire Corporation had been a direct competitor of Chordiant in the past, IBM's acquisition of these companies may indicate that IBM will become a competitor of ours in the future. While the Company currently has good relationship with IBM, this relationship and the Company's strategic relationship agreement with IBM may be harmed if the Company increasingly finds itself competing with IBM. Our relationships with systems integrators and their willingness to recommend our products to their customers could be harmed if the Company were to be subject to a take over attempt from a competitor of such systems integrators.

If systems integrators fail to properly implement our software, our business, reputation and financial results may be harmed.

We are increasingly relying on systems integrators to implement our products, and this trend may continue. As a result, we have less quality control over the implementation of our software with respect to these transactions and are more reliant on the ability of our systems integrators to correctly implement our software. If these systems integrators fail to properly implement our software, our business, reputation and financial results may be harmed.

If we do not maintain effective internal controls over financial reporting, investors could lose confidence in our financial reporting and customers may delay purchasing decisions, which would harm our business and the market price of our common stock.

Effective internal controls are necessary for us to provide reliable financial reports. If we cannot provide reliable financial reports, our business could be harmed. We are a complex company with complex accounting issues and thus subject to related risks of errors in financial reporting which may cause problems in corporate governance, the costs of which may outweigh the costs of the underlying errors themselves. For example, the Audit Committee of the Company's Board of Directors, with the assistance of outside legal counsel, conducted a review of our stock option practices covering the time from the Company's initial public offering in 2000 through September 2006. The Audit Committee reached a conclusion that incorrect measurement dates were used for financial accounting purposes for stock option grants in certain prior periods. As a result, the Company recorded an additional non-cash stock-based compensation expense, and related tax effects, related to stock option grants and concluded that a material weakness surrounding the control activities relating to the stock option grants existed at September 30, 2006. To correct these accounting errors, we restated the Consolidated Financial Statements contained in our Annual Report on Form 10-K for the year ended September 30, 2006 and our Quarterly Report on Form 10-Q for the three months ended June 30, 2006. As a result of this need to restate financial statements, management and the Audit Committee determined that material weaknesses in our internal control over financial reporting existed as of September 30, 2006. These material weaknesses were remediated during fiscal year 2007 and management concluded internal controls over financial reporting were effective for the reporting period.

If we are not successful in maintaining effective internal controls over financial reporting, customers may delay purchasing decisions or we may lose customers, create investor uncertainty, face litigation and the market price of our common stock may decline. For more information, please refer to the discussion under the heading "Item 9A. Controls and Procedures" in the 2006 Annual Report on Form 10-K.

\*If we are not able to successfully manage our partner operations in India, our operations and financial results may be adversely affected.

In 2003, we entered into an agreement with Ness Technologies Inc., Ness Global Services, Inc. and Ness Technologies India, Ltd. (collectively, “Ness”), an independent contracting company with global technical resources and an operations center in Bangalore, India and operations in other locations. The agreement provides for Ness, at our direction, to attract, train, assimilate and retain sufficient highly qualified personnel to perform staffing for consulting projects, technical support, product test and certain sustaining engineering functions. As of March 31, 2008, we use the services of approximately 143 consultants through Ness. In addition, as a result of the reduction in our workforce that took place in July 2005, and the reduction in our workforce that took place in October 2006, by approximately 10% in each instance, we are now more dependent on Ness. This agreement is an important component of our strategy to address the business needs of our customers and manage our expenses. The success of this operation will depend on our ability and Ness’s ability to attract, train, assimilate and retain highly qualified personnel in the required periods. A disruption or termination of our relationship with Ness could adversely affect our operations. Failure to effectively manage the organization and operations will harm our business and financial results.

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If our products do not operate effectively in a company-wide environment, we may lose sales and suffer decreased revenues.

If existing customers have difficulty deploying our products or choose not to fully deploy our products, it could damage our reputation and reduce revenues. Our success requires that our products be highly scalable, and able to accommodate substantial increases in the number of users. Our products are expected to be deployed on a variety of computer software and hardware platforms and to be used in connection with a number of third-party software applications by personnel who may not have previously used application software systems or our products. These deployments present very significant technical challenges, which are difficult or impossible to predict. If these deployments do not succeed, we may lose future sales opportunities and suffer decreased revenues. If we underestimate the resources required to meet the expectations we have set with a customer when we set prices, then we may experience a net loss on that customer engagement. If this happens with a large customer engagement then this could have a material adverse effect on our financial results.

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

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

Because competition for qualified personnel is intense, we may not be able to retain or recruit personnel, which could impact the development and sales of our products.

If we are unable to hire or retain qualified personnel, or if newly hired personnel fail to develop the necessary skills or fail to reach expected levels of productivity, our ability to develop and market our products will be weakened. Our success depends largely on the continued contributions of our key management, finance, engineering, sales and marketing and professional services personnel. In particular in prior years, we have had significant turnover of our executives as well as in our sales, marketing and finance organizations and many key positions are held by people who have less than two years of experience in their roles with the Company. If these people are not well suited to their new roles, then this could result in the Company having problems in executing its strategy or in reporting its financial results. Because of the dependency on a small number of large deals, we are uniquely dependent upon the talents and relationships of a few executives and have no guarantee of their retention. Changes in key sales management could affect our ability to maintain existing customer relationships or to close pending transactions. We have been targeted by recruitment agencies seeking to hire our key management, finance, engineering, sales and marketing and professional services personnel. In addition, in July 2005 and again in October of 2006, we reduced the size of our workforce by approximately 10% in each instance, which may have a negative effect on our ability to attract and retain qualified personnel.

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

Our services revenues have had lower gross margins than our license revenues. Service revenue comprised 75% and 53% of our total revenues for the six months ended March 31, 2008 and 2007, respectively. Gross margin on service revenue was 58% and 56% for the six months ended March 31, 2008 and 2007, respectively. License revenues comprised 25% and 47% of our total revenues for the six months ended March 31, 2008 and 2007, respectively. Gross margins on license revenues were 95% and 96% for the six months ended March 31, 2008 and 2007, respectively.

As a result, an increase in the percentage of total revenues represented by services revenues, or an unexpected decrease in license revenues, could have a detrimental impact on our overall gross margins. To increase services revenues, we expect to expand our services organization, successfully recruit and train a sufficient number of qualified services personnel, enter into new implementation projects and obtain renewals of current maintenance contracts by our customers. This expansion could further reduce gross margins in our services revenues.

We may not have the workforce necessary to support our platform of products if demand for our products substantially increased, and, if we need to rebuild our workforce in the future, we may not be able to recruit personnel in a timely manner, which could negatively impact the development, sales and support of our products.

In July 2005 and again in October of 2006, we reduced the size of our workforce by approximately 10% in each instance. In the event that demand for our products increases, we may need to rebuild our workforce or increase outsourced functions to companies based in foreign jurisdictions and we may be unable to hire, train or retain qualified personnel in a timely manner, which may weaken our ability to market our products in a timely manner, negatively impacting our operations. Our success depends largely on ensuring that we have adequate personnel to support our platform of products as well as the continued contributions of our key management, finance, engineering, sales and marketing and professional services personnel.

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

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

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

We license from several software providers technologies that are incorporated into our products. We anticipate that we will continue to license technology from third parties in the future. This software may not continue to be available on commercially reasonable terms, if at all. While currently we are not materially dependent on any single third party for such licenses, the loss of the technology licenses could result in delays in the license of our products until equivalent technology is developed or identified, licensed and integrated into our products. Even if substitute technologies are available, there can be no guarantee that we will be able to license these technologies on commercially reasonable terms, if at all.

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

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

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

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

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

If our products fail to satisfy advancing technological requirements of our customers and potential customers, the market acceptance of these products could be reduced. We currently serve a customer base with a wide variety of

constantly changing hardware, software applications and networking platforms. Customer acceptance of our products depends on many factors such as:

- Our ability to integrate our products with multiple platforms and existing or legacy systems; and,
- Our ability to anticipate and support new standards, especially Internet and enterprise Java standards.

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

Our business strategy includes pursuing opportunities to grow our business, both through internal growth and through merger, acquisition and technology and other asset transactions. To implement this strategy, we may be involved in merger and acquisition activity and additional technology and asset purchase transactions. Merger and acquisition transactions are motivated by many factors, including, among others, our desire to grow our business, acquire skilled personnel, obtain new technologies and expand and enhance our product offerings. Mergers and acquisitions of high-technology companies are inherently risky, and the Company cannot be certain that any acquisition will be successful and will not materially harm the Company's business, operating

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results or financial condition. Generally, acquisitions involve numerous risks, including the following: (i) the benefits of the acquisition (such as cost savings and synergies) not materializing as planned or not materializing within the time periods or to the extent anticipated (ii) the Company's ability to manage acquired entities' people and processes that are headquartered in separate geographical locations from the Company's headquarters, (iii) the possibility that the Company will pay more than the value it derives from the acquisition, (iv) difficulties in integration of the operations, technologies, content and products of the acquired companies, (v) the assumption of certain known and unknown liabilities of the acquired companies, (vi) difficulties in retaining key relationships with customers, partners and suppliers of the acquired company, (vi) the risk of diverting management's attention from normal daily operations of the business, (vii) the Company's ability to issue new releases of the acquired company's products on existing or other platforms, (viii) negative impact to the Company's financial condition and results of operations and the potential write down of impaired goodwill and intangible assets resulting from combining the acquired company's financial condition and results of operations with its financial statements, (ix) risks of entering markets in which the Company has no or limited direct prior experience; and (x) the potential loss of key employees of the acquired company. Realization of any of these risks in connection with any technology transaction or asset purchase we have entered into, or may enter into, could have a material adverse effect on our business, operating results and financial condition.

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

We expect that software product developers and providers of software in markets similar to our target markets will increasingly be subject to infringement claims as the number of products and competitors in our industry grows and the functionality of products overlap. Additionally, we are seeing copyright infringement claims being asserted by certain third party software developers. Any claims, with or without merit, could be costly and time-consuming to defend, divert our management's attention or cause product delays. If any of our products were found to infringe a third party's proprietary rights, we could be required to enter into royalty or licensing agreements to be able to sell our products. Royalty and licensing agreements, if required, may not be available on terms acceptable to us or at all.

In particular, if we are sued for patent infringement by a patent holding company, one which has acquired large numbers of patents solely for the purpose of bringing suit against alleged infringers rather than practicing the patents, it may be costly to defend such suit. We have received a letter from one such patent holding company alleging that our products may infringe one or more of their patents. We are also the subject of a suit by a person claiming that certain of our products infringe his copyrights. If any of our products were found to infringe such patent or copyrights, the patent or copyright holder could seek an injunction to enjoin our use of the infringing product. If we were not able to remove or replace the infringing portions of software with non-infringing software, and were no longer able to license some or all of our software products, such an injunction would have an extremely detrimental effect on our business. If we were required to settle such claim, it could be costly. A patent or copyright infringement claim could have a material adverse effect on our business, operating results and financial condition.

The application of percentage-of-completion and completed contract accounting to our business is complex and may result in delays in the reporting of our financial results and revenue not being recognized as we expect.

Although we attempt to use standardized license agreements designed to meet current revenue recognition criteria under generally accepted accounting principles, we must often negotiate and revise terms and conditions of these standardized agreements, particularly in multi-product transactions. At the time of entering into a transaction, we assess whether any services included within the arrangement require us to perform significant implementation or customization essential to the functionality of our products. For contracts involving significant implementation or customization essential to the functionality of our products, we recognize the license and professional consulting services revenues using the percentage-of-completion method using labor hours incurred as the measure of progress



towards completion. The application of the percentage-of-completion method of accounting is complex and involves judgments and estimates, which may change significantly based on customer requirements. This complexity combined with changing customer requirements could result in delays in the proper determination of our percentage-of-completion estimates and revenue not being recognized as we expect.

In the past we have also entered into co-development projects with our customers to jointly develop new vertical applications, often over the course of a year or longer. In such cases we may only be able to recognize revenue upon delivery of the new application. The accounting treatment for these co-development projects could result in delays in the recognition of revenue. The failure to successfully complete these projects to the satisfaction of the customer could have a material adverse effect on our business, operating results and financial condition.

Changes in our revenue recognition model could result in short term declines to revenue.

Historically, a high percentage of license revenues have been accounted for on the percentage-of-completion method of accounting or recognized as revenue upon the delivery of product. If we were to enter into new types of transactions accounted for on a subscription or term basis, revenues might be recognized over a longer period of time. The impact of this change would make revenue recognition more predictable over the long term, but it might also result in a short term reduction of revenue as the new transactions took effect.

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We may encounter unexpected delays in maintaining the requisite internal controls over financial reporting and we expect to incur additional expenses and diversion of management's time as a result of performing future system and process evaluation, testing and remediation required to comply with future management assessment and auditor attestation requirements.

In connection with the Company's compliance with Section 404 under SOX for the fiscal years ended September 30, 2006 and 2005, we identified certain material weaknesses. In future periods, we will continue to document our internal controls to allow management to report on, and our independent registered public accounting firm to attest to, our internal control, over financial reporting as required by Section 404 of SOX, within the time frame required by Section 404. We may encounter unexpected delays in implementing those requirements, therefore, we cannot be certain about the timely completion of our evaluation, testing and remediation actions or the impact that these activities will have on our operations. We also expect to incur additional expenses and diversion of management's time as a result of performing the system and process evaluation, testing and remediation required to comply with management's assessment and auditor attestation requirements. If we are not able to timely comply with the requirements set forth in Section 404 in future periods, we might be subject to sanctions or investigation by the regulatory authorities. Any such action could adversely affect our business or financial results.

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## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

On February 28, 2008, the Company's Board of Directors authorized the 2008 Repurchase Plan, a program to repurchase up to \$25 million of the Company's common stock over a one year period. Repurchases under the plan began on March 4, 2008. In conjunction with the 2008 Repurchase Plan, the Company entered into a written trading plan with a broker under Rule 10b5-1 of the Securities Exchange Act of 1934, as amended, to effect the repurchases. The timing and amount of any shares repurchased under the 2008 Repurchase Plan are determined by the Company's management based on its evaluation of market conditions and other factors. Repurchased shares are immediately retired and will resume the status of authorized but unissued shares. The following table sets forth information with respect to repurchases of our common stock during the three months ended March 31, 2008 (in thousands, except shares and average price per share):

| Period                               | Total Number<br>of Shares<br>Purchased | Average<br>Price Paid<br>Per Share | Total<br>Number of<br>Shares<br>Purchased as<br>Part of<br>Publicly<br>Announced<br>Plans<br>or Programs | Approximate<br>Dollar Value<br>of Shares<br>that May<br>Yet Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|--------------------------------------|--|------------------------------------|--|--|
| January 1, 2008 - January 31, 2008   |  | —\$                                | —  | —\$  |
| February 1, 2008 - February 29, 2008 |  | —                                  | —  | —  |
| March 1, 2008 - March 31, 2008       | 1,524,078                              | 6.10                               | 1,524,078  | 15,700   |
| Total                                | 1,524,078                              | \$ 6.10                            | 1,524,078  | \$ 15,700  |

The Company terminated the 2008 Stock Repurchase Plan as of April 30, 2008.

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

On February 1, 2008, our Annual Meeting of Stockholders was held in Cupertino, California. Of the 33,303,036 shares outstanding and entitled to vote as of the record date of December 3, 2007, 29,728,682 shares were present or represented by proxy at the meeting. At the meeting, stockholders were asked to vote with respect to (i) the election of two directors to hold office until the 2011 Annual Meeting of Stockholders or until such time as their respective successors are elected and qualified, (ii) the ratification to amend Chordiant's 2005 Equity Incentive Plan ("the 2005 Plan") to increase the number of shares authorized and reserved for issuance under the 2005 Plan by an additional 700,000 shares of common stock, (iii) the ratification to amend Chordiant's Amended and Restated 1999 Non-Employee Directors' Stock Option Plan (Directors' Plans) to expand the types of awards that may be granted to include restricted stock awards and restricted stock units and for fiscal year 2008 and thereafter, directors will receive awards of restricted stock awards instead of stock options as their annual and initial automatic board service award, and (iv) the ratification of the selection of BDO Seidman, LLP as our independent registered public accounting firm for our fiscal year ending September 30 2008.

The following nominees were elected as directors, each to hold office until the 2011 Annual Meeting of Stockholders or until such time as their respective successors are elected and qualified, by the vote set forth below:

| Nominee                  | Votes For  | Withheld  | Broker<br>Non-Votes |
|--------------------------|------------|-----------|---------------------|
| Steven R.<br>Springsteel | 28,238,421 | 1,490,261 | 0                   |
| Richard G.<br>Stevens    | 28,363,244 | 1,365,438 | 0                   |

In addition to the directors elected above, William J. Raduchel, David R. Springett, Charles E. Hoffman, Dan A. Gaudreau, and Allen A. A. Swann continued to serve as directors after the annual meeting. On February 1, 2008, David A. Weymouth resigned as a member of the Company's Board of Directors.

Stockholders' approval to increase the number of shares authorized and reserved for issuance under the 2005 Plan by an additional 700,000 shares of common stock was ratified by the vote set forth below:

| Votes For  | Votes Against | Abstentions | Broker<br>Non-Votes |
|------------|---------------|-------------|---------------------|
| 21,859,217 | 4,330,782     | 57,358      | 3,481,325           |

Stockholders' approval to amend the Directors' Plans to expand the types of awards that may be granted to include restricted stock awards and restricted stock units and for fiscal year 2008 and thereafter, directors will receive awards of restricted stock awards instead of stock options as their annual and initial automatic board service award:

| Votes For  | Votes Against | Abstentions | Broker<br>Non-Votes |
|------------|---------------|-------------|---------------------|
| 23,238,161 | 2,944,620     | 64,576      | 3,481,325           |

The selection of BDO Seidman, LLP as our independent registered public accounting firm for our fiscal year ended September 30, 2008 was ratified by the vote set forth below:

| Votes For | Votes Against | Abstentions | Broker<br>Non-Votes |
|-----------|---------------|-------------|---------------------|
|-----------|---------------|-------------|---------------------|

28,501,658

1,172,899

54,124

0

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Item 5. Other information

Unregistered Sales of Equity Securities and the Use of Proceeds

On April 30, 2008, the Company terminated the 2008 Stock Repurchase Plan. Under the 2008 Stock Repurchase Plan, the Company repurchased a total of 3.4 million shares of our common stock at an average price of \$5.55 per share totaling \$18.6 million.

Compensatory Arrangements of Certain Officers

On April 30, 2008, the Board of Directors amended the 2008 Executive Plan, 2008 Worldwide Vice President of Professional Services Bonus Plan, and 2008 General Counsel Bonus Plan (or “the Plans”). The amendment allows the measurement of the weighted Non-GAAP Operating Profit component of the Plans for fiscal year 2008 to be calculated using either the original method or using an alternative method (provided that Non-GAAP Operating Profit for fiscal year 2008 is at least a certain identified amount), defaulting to the method that will result in a higher bonus payout. If the alternative method results in a higher payout, it is limited to a maximum aggregate annual payout of \$1.2 million for the Non-GAAP Operating Profit component of the Plans.

Cost Associated with Exit or Disposal Activities

On May 1, 2008, the Company committed to a cost reduction plan intended to align its resources and cost structure with expected future revenues. The plan anticipates a re-allocation of employee resources between functional groups. The plan includes an immediate reduction in positions equal to approximately ten percent of the Company’s worldwide workforce. We notified employees on May 1, 2008.

As a result of the cost-cutting measures, the Company estimates that it will record pre-tax operating charges in the third quarter of fiscal year 2008 of approximately \$0.4 million for severance costs.

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Item 6. Exhibits

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

Chordiant Software, Inc.

SIGNATURES

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

CHORDIANT SOFTWARE, INC

By: /s/ PETER S. NORMAN  
Peter S. Norman  
Chief Financial Officer and  
Principal Accounting Officer

Dated: May 6, 2008

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## EXHIBIT INDEX

| Exhibit<br>Number | Description of Document  |
|-------------------|--|
| 3.1               | Amended and Restated Certificate of Incorporation of Chordiant Software, Inc. (filed as Exhibit 3.1 to Chordiant's Registration Statement on Form S-1 (No. 333-92187) filed on December 6, 1999 and incorporated herein by reference). |
| 3.2               | Amended and Restated Bylaws of Chordiant Software, Inc. (filed as exhibit 3.2 to Chordiant's Form 8-K dated February 1, 2006 and incorporated herein by reference)   |
| 31.1              | Certification required by Rule 13a-14(a) or Rule15d-14(a).   |
| 31.2              | Certification required by Rule 13a-14(a) or Rule15d-14(a).   |
| 32.1#             | Certification required by Rule 13a-14(a) or Rule15d-14(a) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).   |

#The certification attached as Exhibit 32.1 is not deemed filed with the Securities and Exchange Commission and is not incorporated by reference into any filing of Chordiant Software, Inc., whether made before or after the date of this Form 10-Q irrespective of any general incorporation language contained in such filing.