PHOENIX TECHNOLOGIES LTD
Form 10-K
December 14, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT

PURSUANT TO SECTIONS 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

(Mark One)

x Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended September 30, 2006

OR

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period to .

Commission file number 0-17111

PHOENIX TECHNOLOGIES LTD.

(Exact name of registrant as specified in its charter)

Delaware	**04-2685985**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

915 Murphy Ranch Road, Milpitas, CA 95035

(Address of principal executive offices, including zip code)

(408) 570-1000

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:
None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value $.001
Preferred Stock Purchase Rights
(Title of each Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES o NO x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES o NO x

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 x NO o

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

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. Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES o NO x

The aggregate market value of the registrant s Common Stock held by non-affiliates of the registrant as of March 31, 2006 was $144,906,316 based upon the last reported sales price of the registrant s Common Stock on the NASDAQ Global Market on such date. For purpose of this disclosure, shares of Common Stock held by directors and officers of the registrant and by stockholders who own more than 5% of the registrant s outstanding Common Stock have been excluded because such persons may be deemed affiliates of the registrant. This determination is not necessarily a conclusive determination for other purposes.

The number of shares of the registrant s Common Stock outstanding as of November 30, 2006 was 25,437,936.

Documents Incorporated by Reference

Portions of the registrant s definitive proxy statement to be filed pursuant to Regulation 14A in connection with the 2007 annual meeting of its stockholders are incorporated by reference into Part III of this Form 10-K.

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FORWARD-LOOKING STATEMENTS

This report on Form 10-K includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements may include, but are not limited to, statements concerning future liquidity and financing requirements, potential price erosion, plans to make acquisitions, dispositions or strategic investments, expectations of sales volume to customers and future revenue growth, plans to improve and enhance existing products, plans to develop and market new products, trends we anticipate in the industries and economies in which we operate, and other information that is not historical information. Words such as could , expects , may , anticipates , believes , projects , estimates , intends , plans , and other similar expre intended to indicate forward-looking statements. All forward-looking statements included in this document reflect our current expectations and various assumptions, and are based upon information available to us as of the date hereof. Our expectations, beliefs and projections are expressed in good faith, and we believe there is a reasonable basis for them, but we cannot assure you that our expectations, beliefs and projections will be realized.

Some of the factors that could cause actual results to differ materially from the forward-looking statements in this Form 10-K include the factors described in the section of this Form 10-K entitled Item 1A-Risk Factors. These factors include, but are not limited to: whether and when we will be able to return to profitability and positive cash flow; our ability to transition from our historical reliance on paid-up licenses to volume purchase agreements and pay-as-you-go arrangements; our dependence on the timing of other industry participants release of technology, in particular, the impact of a continued delay of Microsoft s Vista operating system on sales of our products; whether our restructurings in 2006 and the first quarter of 2007 prove to be successful in improving our efficiency of operations and whether further restructurings become necessary; whether our recent reductions in workforce will have a materially negative impact on employee morale or our ability to fulfill contractual obligations; the results of our current assessment of strategic alternatives for the Company; our ability to successfully enhance existing products and develop and market new products and technologies; our ability to attract and retain key personnel; our ability to successfully integrate our new members of senior management; variations in demand for secure and available digital devices; the rate of adoption of new operating system and microprocessor design technology; trends regarding the use of the x86 microprocessor architecture for personal computers and other digital devices; the ability of our customers to successfully introduce and market new products that incorporate our products; risks associated with our acquisition strategy; results of litigation; failure to protect our intellectual property rights; changes in our effective tax rates; our ability to successfully sell into new markets where we do not have significant prior experience; changes in financial accounting standards and our cost of compliance; changes in our relationship with leading software and semiconductor companies; our dependence on key customers; product and price competition in our industry; risks associated with our international sales and other activities, including currency fluctuations, acts of war or global terrorism, and changes in laws and regulations relating to our employees in international locations; and the effects of software viruses, power shortages and unexpected natural disasters. If any of these risks or uncertainties materialize, or if any of our underlying assumptions are incorrect, our actual results may differ significantly from the results that we express in or imply by any of our forward-looking statements. We do not undertake any obligation to revise these forward-looking statements to reflect future events or circumstances.

PART I

ITEM 1. BUSINESS

Description of Business

Phoenix Technologies Ltd. (the Company) designs, develops and supports core system software for personal computers or PCs and other computing devices. Our products, which are commonly referred to as firmware, support and enable the compatibility, connectivity, security, and manageability of the various components and technologies used in such devices. We sell these products primarily to computer and component device manufacturers. We also provide training, consulting, maintenance and engineering services to our customers.

The majority of the Company s revenue comes from Core System Software (CSS), the modern form of BIOS (Basic Input-Output System), for personal computers, servers and embedded devices. Our CSS customers are primarily original equipment manufacturers (OEMs) and original design manufacturers (ODMs), who build in CSS products during the manufacturing process. The CSS is typically stored in non-volatile memory on a chip that resides on the motherboard built into the device. The CSS is executed during the power up in order to test, initialize and manage the functionality of the device s hardware. Our CSS products are incorporated in over 100 million devices per year, giving us global market share leadership in this sector.

The Company also licenses software developer kits (SDKs) to qualified partners for the development of core-resident, integrated, value-add software applications built on our CSS platform. These partners, including independent software vendors, independent hardware vendors, OEMs, ODMs, system integrators, and system builders, can build and deploy applications in categories such as utilities, productivity, security, and content delivery using our development tools.

The Company has developed and markets a family of software application products that restore a device s data, enable device identification to a network, and provide instant-on access to certain frequently used applications. Although the true end-users of these applications products are enterprises, governments and service providers, we typically sell these solutions as firmware to OEMs and ODMs to assist them in making their products attractive to those end-users.

Finally, the Company derives additional revenue from providing support services such as training, maintenance and engineering expertise to our software customers.

The global electronics industry is characterized by rapid technology changes, including increasing processor speeds, hardware miniaturization, portability, and new and improved ways to connect devices over both wired and wireless networks. As these rapid changes occur, computing hardware manufacturers and software developers seek to rapidly bring products to market that incorporate the latest features and functionality. The Company believes that its firmware products and related services enable both hardware manufacturers (of PCs and PC components) and software manufacturers (of both operating systems and applications) to bring leading edge products to market more quickly and thereby increase their competitiveness. Please see Item 7 Management s Discussion and Analysis and Item 8 Financial Statements and Supplementary Data for information regarding our operations and financial situation.

The Company was incorporated in the Commonwealth of Massachusetts in September 1979, and was reincorporated in the State of Delaware in December 1986. The Company s headquarters is in Milpitas, California. The mailing address of our headquarters is 915 Murphy Ranch Road, Milpitas, CA 95035, and the telephone number at that location is +1 (408) 570-1000.

Recent Developments

Investigation of Strategic Alternatives

On July 12, 2006, we announced our engagement of Savvian LLC, an independent investment bank, to assist our Board of Directors and management in assessing strategic alternatives to maximize stockholder value. No assumption should be made that any transaction will be entered into or consummated as a result of this review. Moreover, our investigation of strategic alternatives may result in diversion of management s attention from normal daily operations of the business and potential loss of customers and key employees and may also give rise to added costs.

New Management Team

Woodson M. Hobbs joined Phoenix as President and Chief Executive Officer and as a member of the Board of Directors of the Company in September 2006. Richard W. Arnold joined the Company in September 2006 as Executive Vice President, Strategy and Corporate Development and was appointed Chief Financial Officer in November 2006. Dr. Gaurav Banga joined the Company as Senior Vice President, Engineering and Chief Technology Officer in October 2006.

Decreased Reliance on Paid-Up Licenses

During fiscal year 2005 and much of fiscal year 2006, we had increasingly relied on the use of paid-up software license agreements. Under paid-up license agreements, customers pay a fixed upfront fee for an unlimited number of units. Generally, we recognize all license revenues under a paid-up license agreement upon execution of the agreement, provided all revenue recognition criteria have been met. Total paid-up license revenue for all sectors represented $30.5 million or 50% of total revenues in fiscal year 2006 compared to $43.0 million or 43% of total revenues in fiscal year 2005.

During the third quarter of fiscal year 2006, we began changing our software licensing practices away from heavy reliance on paid-up licenses to volume purchase agreements for large customers and pay-as-you-go or royalty-based arrangements with smaller customers. We have now ended the use of paid-up licenses effective September 2006. In combination with other changes to our sales processes and pricing practices, we believe that this shift in the manner in which we license our products will assist us in achieving higher average selling prices for our products and having greater predictability of revenues than has been the case in recent periods.

Decreased Focus on Enterprise Application Products

For the majority of fiscal year 2006, we were allocating considerable resources towards the development of a reseller channel for a number of application products with the expectation that our channel partners would assist us in selling these products to enterprises, governments and service providers. During the fourth quarter of fiscal year 2006, due to high costs incurred in selling our products in the enterprise market, we decided to refocus our application products sales, marketing and development efforts so as to concentrate primarily on sales to the PC and component manufacturers rather than continuing with the channel sales initiatives.

Restructuring Plans

In fiscal year 2006, we implemented a number of cost reduction plans in order to reduce costs which were not integral to our overall strategy and to better align our expense levels with our anticipated revenues.

In the third quarter of fiscal year 2006, management approved a restructuring plan designed to reduce operating expenses by eliminating 35 positions and closing facilities in Munich, Germany and Osaka, Japan. The Company recorded $1.8 million of employee severance costs and $0.2 million of facility closure costs during the fiscal year. In the fourth quarter of fiscal year 2006, management approved additional restructuring plan designed to reduce operating expenses by eliminating an additional 68 positions. The Company recorded $2.2 million of employee severance costs. We expect to incur an additional restructuring charge of approximately $0.3 million during the first quarter of fiscal year 2007 related to closing facilities in Zaltbommel, the Netherlands.

During the first quarter of fiscal year 2007, the Company announced an additional restructuring plan and expects to record a restructuring charge of approximately $1.8 million related to a further reduction in force of 62 positions, primarily related to employees in the U.S. and Japan.

With the fiscal year 2006 and first quarter of fiscal year 2007 restructuring plans along with other staff reductions that have occurred in the ordinary course of business, the Company expects that it will have reduced total headcount by approximately 35%, from 521 employees at the end of the second quarter of fiscal year 2006 to approximately 335 employees at January 1, 2007, the beginning of the second quarter of fiscal year 2007.

Products

Described below are certain selected products sold by the Company.

Phoenix CSS

Phoenix s CSS products include:

Phoenix TrustedCore

Phoenix TrustedCore® is our current primary CSS product group, and consists of the firmware that runs many of today s computers. TrustedCore supports and enables the compatibility, connectivity, security, and manageability of the various components of modern desktop and notebook PCs, network-connected servers and embedded computing systems. TrustedCore enhancements released during fiscal year 2006 are primarily related to add-ons and plug-ins designed to secure access to the device and data and to provide license policy enforcement.

In addition, the TrustedCore products can be easily customized to meet the configuration requirements of various target markets using development tools that we offer. For example, we offer a visual development environment, Phoenix CoreArchitectTM, which is integrated with Microsoft s Visual Studio .NET, and provides our ODM and OEM partners with modular design and leading-edge visual development tools to deliver improved time to market and better return on investments in firmware development.

Award BIOS

Phoenix Award BIOSTM product family supports fast time to market and low cost for high volume PC and digital device electronics design and manufacturing companies. Typically these manufacturers operate on short design and product life cycles, and there is tremendous cost competition among them. Phoenix Award BIOS delivers the standards-based features, simplicity and small code size necessary for this dynamic market segment.

FirstBIOS

This product was the predecessor to TrustedCore. The Company made the decision during fiscal year 2006 to discontinue sale of the FirstBIOSTM family of products as it believed the market was adequately served by our other two CSS product lines.

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Developments in Core System Software

Over recent years, the Company, along with other key partners, have pioneered a new overall design concept for Core System Software known as Unified Extensible Firmware Interface (UEFI), which is now supported by a wide industry consortium, including Microsoft, Intel and AMD. Under this design concept and open industry standard, firmware becomes somewhat more modular and standardized than had previously been the case, allowing for individual developers to build add-ons, or plug-ins to standard interface specifications, and hence to deliver products that may be incorporated with UEFI compliant firmware platforms from a variety of vendors.

The TrustedCore architecture today incorporates the UEFI standards, and hence supports various device drivers and value added service offerings known as add-ons and plug-ins that we and others intend to sell in the future.

Phoenix Applications

Phoenix s application products include:

Phoenix Recover Family

Phoenix RecoverTM Manufacturing software gives manufacturers the ability to store an operating system and applications software on a computing device in a tamper-proof, locked-down partition that only the Phoenix Recover applications can access. This application can then restore the operating system and applications software without a boot disk or recovery CD. In addition**,** Phoenix Recover ProTM 6 provides end-users with the capability to recover data and applications and restore the PC (including the operating system and applications software) to any chosen point without the need for a boot disk, recovery CDs or back-up media. Recover Pro 6 is designed to increase end-user productivity and reduce costs associated with IT and help desk services. In the fourth quarter of fiscal year 2006, we discontinued selling our older generation Recover and, Recover Pro 2004 Manufacturing products and we discontinued our efforts to sell the Recover products to enterprise companies, either directly or through reseller channels.

Phoenix Always

Phoenix AlwaysTM is an embedded operating system and application platform that provides an environment independent of the user s operating system in which various Phoenix and third party applications can run. The Phoenix Always software product provides OEMs and system builders with an instant-on , tamper resistant, and easy-to-customize user environment that can not be over-written by virus or malware attacks, or even by the operating system itself. The Phoenix Always software product includes pre-configured functions designed to help system builders and OEMs differentiate their product offerings and generate new revenue streams through the support of pre-operating system applications.

Phoenix TrustConnector

Phoenix TrustConnectorTM is a software product that is integrated with Phoenix CSS products to provide seamless device identity and strong authentication for Windows, Linux and Cisco network environments. Phoenix TrustConnector provides platform-secured methods for creating and protecting device keys while ensuring that policy enforcement credentials can be used only on the system to which they are issued. For systems with Phoenix TrustedCore or its predecessor Phoenix FirstBIOS Core System Software, the TrustConnector application takes advantage of the CSS cryptographic capabilities to secure private keys in hardware, protected from unauthorized access.

Phoenix TCSubscribe

The Phoenix TCSubscribeTM module integrates with the Phoenix TrustedCore platform creating a secure, tamper-resistant policy enforcement engine for pay-as-you-go and subscription-based computing on x86 devices. The TCSubscribe reference design for Microsoft FlexGo technology was jointly specified and developed with Microsoft to provide secure usage metering and the ability to protect service provider investments from default or tampering.

Sales and Marketing

The Company markets and sells its CSS products and services through a global direct sales force with sales offices in North America, Japan and the Asia Pacific, as well as through a network of regional distributors and sales representatives, to OEMs, ODMs, resellers, system integrators, system builders and independent software vendors.

Our CSS products are sold directly to OEMs and ODMs of PCs and of embedded systems. We sell our CSS products to various global technology leaders, including:

Original Equipment Manufacturers		
Dell Computer Corporation	IBM Corporation	Samsung Electronics Co. Ltd.
Fujitsu Limited	Lenovo Group Ltd.	Sony Corporation
Fujitsu Siemens Computer	Matsushita Electronic Corp.	Toshiba, Inc.
Hewlett Packard Company	NEC Corporation	Sharp Corporation
Foxconn eMS, Inc.		

Original Design Manufacturers	**MotherBoard Manufacturers**	**Non-PC Systems**
Arima Computer Corporation	ASUSTeK Computer, Inc.	Motorola, Inc.
Compal Electronics, Inc.	Elitegroup Computer Systems, Inc.	NCR Corporation
First International Computer, Inc.	Gigabyte Technology Co., Ltd.	NEC Corporation
Quanta Corporation	Micro-Star International Co., Ltd.	Taito Corporation
Wistron Corporation		Shanda Computer Co., Ltd.
		Advantech Co., Ltd.

Our applications products are sold to our CSS customers, as well as to resellers and system builders. The Company s major customers for these products during the past two years include Lenovo (Singapore) PTE Ltd., Fujitsu Siemens Computer GMBH, Samsung Electronics Co. Ltd., Quanta Corporation, Compal Electronics, Inc., IBM, Wistron Corporation and ASUSTeK Computer, Inc.

Significant Customers

Fujitsu Ltd. accounted for 12% of the Company s total revenues in fiscal year 2006. Lenovo (Singapore) Pte. Ltd. and Quanta Computer Inc. accounted for 15% and 12% of the Company s total revenues in fiscal year 2005. IBM accounted for 11% of the Company s total revenues in fiscal year 2004. No other customer accounted for more than 10% of total revenues in fiscal years 2006, 2005, or 2004. The Company typically does not have significant order backlog at any given time and carries no inventory. Additionally, the Company does not provide customers with rights of return nor does it normally provide customers with extended payment terms.

International Sales and Activities

Revenues derived from international sales comprise a majority of total revenues. During fiscal years 2006, 2005, and 2004, $54.1 million, or 89%, $74.7 million, or 75%, and $70.4 million, or 81% of total revenues, for each of the respective years, were derived from sales outside of the U.S. See Note 8 to our

Consolidated Financial Statements for information relating to revenues by geographic area. We have international sales and engineering offices in Germany, Japan, Korea, Taiwan, Hong Kong, China and India. The major portion of our license fee or royalty contracts are U.S. dollar denominated, however, we do enter into non-recurring engineering (NRE) service contracts in Japan in local currency.

In addition, an increasing percentage of our labor force, particularly in engineering, is located in China, Taiwan and India. Approximately 66% or 235 employees are located outside of the U.S. as of November 30, 2006.

Competition

The Company competes for CSS sales primarily with in-house research and development (R&D) departments of PC and component manufacturers such as Dell, Hewlett Packard, Toshiba and Intel that may have significantly greater financial and technical resources, as well as closer engineering ties and experience with specific hardware platforms, than we do. We believe that OEM and ODM customers often license our CSS products rather than develop these products internally in order to: (1) differentiate their system offerings with advanced features, (2) easily leverage the additional value of our other software solutions, (3) improve time to market, (4) reduce product development risks, (5) minimize product development and support costs, and/or (6) enhance compatibility with the latest industry standards.

The Company also competes for CSS sales with other independent suppliers, including American Megatrends Inc., a privately held company, and other BIOS companies.

In applications software, as with CSS, the Company competes with in-house R&D as well as third party solutions. Our applications that reside in the protected area of the hard drive also compete with individual component software and diagnostic and repair software from other companies, as well as PC manufacturer-developed solutions. Price and product performance are the principal method of competition in this market. We consider our competitive advantage to be our existing business relationships, our years of experience, our intellectual property, and our ability to provide integrated solutions on existing CSS deployments.

Product Development

The Company constantly seeks to develop new products, maintain and enhance our current product lines, maintain technological competitiveness, and meet continually changing customer and market requirements. Our research and development expenditures in fiscal years 2006, 2005, and 2004 were $22.9 million, $20.4 million, and $22.4 million, respectively. All of our expenditures for research and development have been expensed as incurred. At November 30, 2006, the Company s research and development and customer engineering group included 232 full-time employees.

Intellectual Property and Other Proprietary Rights

The Company relies primarily on U.S. and foreign patents, trade secrets, trademarks, copyrights, and contractual agreements to establish and maintain proprietary rights in our technology. We have an active program to file applications for and obtain patents in the U.S. and in selected foreign countries where there is a potential market for our products. As of September 30, 2006, we have been issued 77 patents in the U.S. and had 41 patent applications in process in the U.S. Patent and Trademark Office. On a worldwide basis, we have been issued 151 patents with respect to our product offerings and have 143 patent applications pending with respect to certain products we market. There can be no assurance that any of these patents would be upheld as valid if challenged. Of the key patents and copyrights that are most closely tied to our product offerings, none are set to expire within the next eight years.

The Company s general policy has been to seek patent protection for those inventions and improvements likely to be incorporated in our products or otherwise expected to be of long-term value. We protect the source code of our products as trade secrets and as unpublished copyrighted works. We may also initiate litigation where appropriate to protect our rights in that intellectual property. We license the source code for our products to our customers for limited uses. Wide dissemination of our software products makes protection of our proprietary rights difficult, particularly outside the United States. Although it is possible for competitors or users to make illegal copies of our products, we believe the rate of technology change and the continual addition of new product features lessen the impact of illegal copying.

In recent years, there has been a marked increase in the number of patents applied for and issued with respect to software products. Although we believe that our products do not infringe on any copyright or other proprietary rights of third parties, we have no assurance that third parties will not obtain, or do not have, intellectual property rights covering features of our products, in which event we or our customers might be required to obtain licenses to use such features. If an intellectual property rights holder refuses to grant a license on reasonable terms or at all, we may be required to alter certain products or stop marketing them.

Compliance with Environmental Regulations

The Company s compliance with federal, state and local provisions enacted or adopted for protection of the environment has had no material effect upon our capital expenditures, earnings or competitive position.

Employees

As of November 30, 2006, we employed 356 full-time employees worldwide, of whom 232 were in research and development and customer engineering, 55 were in sales and marketing, and 69 were in general administration. Our employees are not represented by a labor organization and we have never experienced a work stoppage. We consider our employee relations to be satisfactory.

Executive Officers of the Company

The executive officers of the Company serve at the discretion of the Board of Directors of the Company. As of the filing date of this Form 10-K, the executive officers of the Company are as follows:

Name	Age	Position
Woodson M. Hobbs	59	President and Chief Executive Officer
Richard W. Arnold	59	Executive Vice President, Strategy and Corporate Development and Chief Financial Officer
Dr. Gaurav Banga	34	Senior Vice President, Engineering and Chief Technology Officer
David L. Gibbs	49	Senior Vice President and General Manager, Worldwide Field Operations
Scott C. Taylor	42	Senior Vice President, General Counsel, and Chief Administrative Officer

BIOGRAPHIES

Mr. Hobbs joined the Company as President and Chief Executive Officer and as a member of the Board of Directors of the Company in September 2006. Prior to joining the Company, Mr. Hobbs served as president, chief executive officer and a member of the board of Intellisync Corporation, a provider of platform-independent wireless messaging and mobile software, from 2002 to 2006. Between 1995 and 2002, Mr. Hobbs was a consulting executive for the venture capital community and a strategic systems consultant to large corporations. During this timeframe, he held the position of interim chief executive officer for various periods at the following companies: FaceTime Communications, a provider of instant messaging network-independent business solutions; Tradenable, Inc., an online escrow service company; BigBook, Inc., a provider in the online yellow pages industry; and I/PRO Corporation, a provider of quantitative measurement of Web site usage. From 1993 to 1994, Mr. Hobbs served as chief executive officer of Tesseract Corporation, a human resources outsourcing and software company. Mr. Hobbs spent the early part of his career with Charles Schwab Corporation, a securities brokerage and financial service company, as chief information officer and with Service Bureau, a division of IBM, as one of the developers and the director of operations of Online Focus, an online credit union system.

Mr. Arnold joined the Company as Executive Vice President, Strategy and Corporate Development in September 2006 and was appointed Chief Financial Officer in November 2006. Prior to joining the Company, Mr. Arnold served as a member of the board of the Intellisync Corporation from 2004 to 2006. Since 2001, Mr. Arnold has served as founding partner of Committed Capital Proprietary Limited, a private equity investment company based in Sydney, Australia. From 1999 to 2001, Mr. Arnold served as executive director of Consolidated Press Holdings Limited, also a private investment company based in Sydney. Mr. Arnold has also previously served as managing director of TD Waterhouse Australia, a securities dealer; as chief executive officer of Integrated Decisions and Systems, Inc., an application software company; as managing director of Eagleroo Proprietary Limited, a corporate advisory company; and in various capacities with Charles Schwab & Company., Inc., a securities and financial services brokerage, including serving as chief financial officer and as executive vice president Strategy and Corporate Development. Mr. Arnold holds a B.S. degree in psychology from Stanford University.

Dr. Banga joined the Company as Senior Vice President, Engineering and Chief Technology Officer in October 2006. Prior to joining the Company, he was Vice President of Product Management at Intellisync (and at Nokia Inc., after its acquisition of Intellisync), responsible for all client-side products. Before Intellisync, Dr. Banga was co-founder and chief executive officer of PDAapps, the creator of VeriChat, a mobile instant messaging solution. PDAapps was acquired by Intellisync in 2005. From 1998 to 2005, Dr. Banga was a Senior Engineer at Network Appliance. Dr. Banga holds a B.Tech. in computer science and engineering from the Indian Institute of Technology, Delhi as well as M.S. and Ph.D. degrees in computer science from Rice University.

Mr. Gibbs joined the Company as Vice President of Business Development in March 2001, was promoted to Senior Vice President and General Manager of the Information Appliance Division in May 2001, became Senior Vice President and General Manager of the Global Sales and Support Division in October 2001, and then became Senior Vice President and General Manager, Worldwide Field Operations in October 2005. From 1998 to 2001, Mr. Gibbs served as Vice President, Sales and Asia Pacific Strategic Accounts Manager at FlashPoint Technologies, a company that provides embedded software solutions. From 1997 to 1998, Mr. Gibbs was Vice President of Sales at DocuMagix, Inc. Mr. Gibbs held a number of executive sales and business development positions with Insignia Solutions from 1993 to 1997. Mr. Gibbs holds a bachelor s degree in economics from the University of California at Los Angeles.

Mr. Taylor joined the Company as Associate General Counsel in January 2002, was promoted to Vice President, General Counsel and Secretary in January 2004, and was promoted to Senior Vice President in

February 2006 and to Chief Administrative Officer in November 2006. From 2000 to 2001, Mr. Taylor was Vice President and General Counsel of Narus, Inc. From 1998 to 2000, Mr. Taylor worked for Symantec Corporation, first as Corporate Counsel and then as Director in the Legal Department. Mr. Taylor was a commercial transactions and corporate attorney with the San Francisco-based law firm of Pillsbury Madison & Sutro (now Pillsbury Winthrop Shaw Pittman) from 1992 to 1998. Mr. Taylor holds a bachelor s degree in International Relations from Stanford University and a juris doctor degree from George Washington University.

Available Information

The Company s website is located at www.phoenix.com. Through a link on the Investor Relations section of our Website, we make available the following filings as soon as reasonably practicable after they are electronically filed with or furnished to the SEC: the Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934. All such filings are available free of charge. Information contained on our website is not part of this report.

ITEM 1A. RISK FACTORS

The following factors should be considered carefully when evaluating our business.

Net Losses

In fiscal year 2006, we reported a net loss of $44.0 million, a net decrease in cash and cash equivalents and marketable securities of $14.5 million and used net cash in operating activities of $13.8 million. We anticipate that we will also incur a net loss and a negative net cash flow during fiscal year 2007. There can be no assurance that we will achieve profitability or positive cash flow in any future periods. If we do not become profitable within the timeframe expected by securities analysts or investors, the market price of our stock will likely decline.

We believe that we currently have sufficient liquidity to operate our business over the short term; however, our ability to meet our capital requirements over the long term depends upon the return of our operations to profitability and positive cash flow.

Reliance on Paid-Up Licenses

Over fiscal year 2005 and the first half of fiscal year 2006, we increased our use of paid-up license agreements. Under paid-up license agreements, customers pay a fixed up-front fee to install the applicable product on an unlimited number of devices. Generally, we would recognize all license revenues under a paid-up license agreement upon execution of the agreement, provided all revenue recognition criteria have been met. Paid-up license agreements may have the effect of accelerating revenue into the quarter in which the agreement is executed and thereby decreasing recurring revenues in later quarters. Beginning in the third quarter of fiscal year 2006, we elected to significantly decrease the use of paid-up license agreements and, as of the beginning of fiscal year 2007, to eliminate their use entirely in favor of volume purchase agreements and pay-as-you-go or royalty-based licensing agreements. Decreasing the number of paid-up license agreements contributed along with other factors to a substantial drop in license revenues in the third and fourth quarters of 2006. Paid-up license revenue represented only approximately 15% of net revenues in the fourth quarter of fiscal year 2006 and 34% of net revenues in the third quarter of fiscal year 2006 as compared to 60% of net revenues in the second quarter of fiscal 2006 and 63% of net revenues in the first quarter of fiscal year 2006. There can be no assurance that we will be successful in increasing the number of volume purchase agreements and pay-as-you-go arrangements, in which case, our license revenue may continue to be weak in future quarters.

Restructurings to Reduce Operating Expenses

In fiscal year 2006, our management approved two restructuring plans designed to reduce operating expenses by eliminating a total of 103 positions and closing facilities in Munich, Germany, Osaka, Japan, Zaltbommel, the Netherlands and Rockville, Maryland. During the first quarter of fiscal year 2007, the Company announced an additional restructuring plan to effect a further reduction in force of 62 positions, primarily related to employees in the U.S. and Japan. In connection with these plans, we incurred $4.2 million of restructuring costs in fiscal year 2006 and approximately $2.1 million of restructuring costs in the first quarter of fiscal year 2007. Due to the uncertainties of predicting our future revenues and potential changes in industry and market conditions, we may need to consider further strategically realigning our resources through additional restructuring or by disposing of, or otherwise exiting one or more of our current businesses.

There can be no assurance that our restructurings in 2006 and the first quarter of 2007, as well as any future restructurings, and related transition issues associated with such restructurings will not adversely affect our operations or customer perceptions. The uncertainty caused by such restructurings could result in a lack of focus and reduced productivity by our remaining employees, including those directly responsible for revenue generation, which in turn may affect our revenue in the future.

Any decision to limit investment in, or dispose of or otherwise exit businesses may result in the recording of special charges, such as technology related write-offs, workforce reduction costs, or charges relating to consolidation of excess facilities. Our estimates with respect to the useful life or ultimate recoverability of our carrying basis of assets, including purchased intangible assets, could change as a result of such decisions. Further, our estimates relating to the liabilities for excess facilities are affected by changes in real estate market conditions. Additionally, we are required to perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances. There can be no assurance that future goodwill impairment tests will not result in a charge to earnings.

Reductions in Workforce

As a result of our three restructuring plans announced during fiscal year 2006 and the first quarter of fiscal year 2007, as well as other staff reductions that have occurred in the ordinary course of business, the Company expects that by the beginning of the second quarter of fiscal year 2007, we will have reduced total headcount by approximately 35%, from 521 employees at the end of the second quarter of fiscal year 2006 to approximately 335 employees at January 1, 2007. Because of the magnitude of the workforce reductions, it is uncertain whether these layoffs will have a material impact on our ability to meet our existing contractual obligations and whether we will be able to timely and efficiently expand our operations in the future to meet customers needs.

Fluctuations in Operating Results

Our future operating results may vary substantially from period to period. The timing and amount of our license fees are subject to a number of factors that make estimating revenues and operating results prior to the end of a quarter uncertain. While we receive recurring revenues from royalty-based license agreements and some agreements contain minimum quarterly royalty commitments, historically, a significant amount of license fees in any quarter were derived from paid-up licenses and thus were dependent on signing agreements and delivering the licensed software in that quarter. As discussed further in the risk factor above, as of the beginning of fiscal year 2007, we have decided to eliminate the use of paid-up licenses.

Generally, we have in the past experienced a pattern of recording 50% or more of our quarterly revenues in the third month of the quarter. We have historically monitored our revenue bookings through regular, periodic worldwide forecast reviews within the quarter. There can be no assurances that this process will result in our meeting revenue expectations. Our planned operating expenses for any year are normally based on the attainment of planned revenue levels for that year and are generally incurred ratably throughout the year. As a result, if revenues were less than planned in any period while expense levels remain relatively fixed, our operating results would be adversely affected for that period. In addition, unplanned expenses could adversely affect operating results for the period in which such expenses were incurred.

Investigation of Strategic Alternatives

On July 12, 2006, we announced our engagement of Savvian LLC, an independent investment bank, to assist our Board of Directors and management in assessing strategic alternatives to maximize stockholder value. No assumption should be made that any transaction will be entered into or consummated as a result of this review. Moreover, our investigation of strategic alternatives may result in added costs and potential loss of customers and key employees as well as diversion of management s attention from normal daily operations of the business.

Product Development

Our long-term success will depend on our ability to enhance existing products and to introduce new products in a timely and cost-effective manner that meet the needs of customers in existing and emerging markets. There can be no assurance that we will be successful in developing new products or in enhancing existing products or that our new and/or enhanced products will be introduced before our competitors new releases, or that our products will meet market requirements. Delays in introducing new products can adversely impact acceptance and revenues generated from the sale of such products. We have, from time to time, experienced such delays. Our software products and their enhancements contain complex code that may contain undetected errors and/or bugs when first introduced. There can be no assurance that new products or enhancements will not contain errors or bugs that will adversely affect commercial acceptance of such new products or enhancements.

Attraction and Retention of Key Personnel

The success of our business will continue to depend upon certain key technical and senior management personnel, including Woodson Hobbs, our new Chief Executive Officer, Richard Arnold, our new Chief Financial Officer, and Dr. Gaurav Banga, our new Chief Technology Officer. Competition for such personnel is intense, and there can be no assurance that we will be able to retain our existing key managerial, technical, or sales and marketing personnel. The loss of these officers or other key employees in the future might adversely affect our business and impede the achievement of our business objectives.

In addition, our ability to achieve increased revenues and to develop successful new products and product enhancements will depend in part upon our ability to attract and retain highly skilled engineering, sales, marketing and administrative personnel. In the event that we expand into new products and new markets, we would probably need to hire people with backgrounds different from those required for our traditional CSS business. A failure to attract and retain employees with the necessary skill sets could adversely affect our business and operating results.

Integration of Officers

We recently hired a new Chief Executive Officer, a new Chief Financial Officer and a new Chief Technology Officer, and may, in the future, hire additional officers and key employees. To integrate into our Company, new executives and employees must spend a significant amount of time learning our business model and management system, in addition to performing their regular duties. Accordingly, the integration of new personnel may result in some disruption to our ongoing operations. If we fail to complete this integration in an efficient manner, our business and financial results will suffer.

End-User Demand for Device Security and Availability

Many of our current products and product features, such as the Phoenix Recover Family of products, TrustConnector, and the security-related features in TrustedCore, are focused on helping to ensure that PCs and other digital devices are secure and available to the users, with a minimum of user skill required for end-users to use these products. The success of our strategy depends on continued growth in end-user demand for these capabilities. Although factors such as global terrorism, increased instances of malware, and increased end-user reliance on their digital devices have all contributed to significant growth in demand for security-related products over the last several years, it is difficult to predict whether these trends will continue, accelerate or decelerate. Variations in demand for secure and available digital devices below our expectations could have a significant adverse impact on our operating results.

Demand for Microsoft s Vista Operating System and for Newer Microprocessor Designs

The adoption of new primary PC technology related to operating systems and to microprocessor designs may have a significant impact on the relative demand for our different CSS products. In particular, Microsoft s new Vista operating system is designed to support security capabilities that will operate more effectively on PCs running TrustedCore than on those running our older CSS versions. Similarly, some newer microprocessor designs offered by the silicon chip vendors may require the functionality provided by TrustedCore to take full advantage of the new designs enhancements. For example, TrustedCore is designed to be easily adaptable for the newer generation of multiple-core microprocessors offered by Intel and AMD, including Intel s dual-core, while our older CSS versions will require more customization effort by our customers. As a result, the demand for TrustedCore could vary in proportion to the rate at which Vista and these newer microprocessor designs are adopted. Such variations would not necessarily lead to changes in our market share for CSS; however, because we have entered into a significantly larger number of paid-up license agreements for our older CSS products than for TrustedCore, our future reported revenues could be affected to the extent that revenues related to our older CSS products may already have been recognized. Moreover, any further delays in the launch of the consumer version of Microsoft s Vista operating could adversely affect the revenues that we will generate from sales of TrustedCore and other products.

Market for Device Designs Based on the x86 Microprocessor Architecture

Our current CSS products are designed for systems built with digital microprocessors based on derivatives of the Intel product used in the original IBM PC/XT/AT. This microprocessor design is commonly called x86 and current suppliers include Intel and AMD. The largest market for x86 microprocessors is personal computer systems including desktop PCs, mobile PCs and volume servers. Competing microprocessor designs dominate numerous other significant markets, including mobile phones, consumer electronics, PDAs, telematics, digital photography and telecommunications. There can be no assurance that x86 microprocessors will continue to hold a large market share of personal computer system designs. There can also be no assurance that corporations and consumers will continue to purchase traditional desktop and mobile PC designs instead of substitute products such as digital wireless handsets and other consumer digital electronic devices which may utilize other microprocessor designs.

Dependence on New Product Releases by Our Customers

Successful introduction of new products is key to our success in both our CSS and new applications businesses. Frequently our new products are used in our customers new products, making each of us dependent on the other for product introduction schedules. It can happen that a customer may not be able to introduce one of its new products for reasons unrelated to our new product. In these cases, we would not be able to ship our new product until the customer had resolved its other problems.

Due to market uncertainties in certain geographic regions, customers may delay their product introductions. If our customers delay their product introductions, our ability to generate revenue from our own new products would be adversely affected.

Risks in Acquisitions

Our growth is dependent upon market growth and our ability to enhance our existing products and introduce new products on a timely basis. We have addressed and are likely to continue to address the need to introduce new products through both internal development and through acquisitions of other companies and technologies. Acquisitions involve numerous risks, including the following:

- Difficulties in integrating the operations, technologies, products and personnel of the acquired companies;
- Diversion of management s attention from normal daily operations of the business;
- Potential difficulties in completing projects associated with in-process research and development;
- Difficulties in entering markets in which we have no or limited direct prior experience and where competitors in such markets have stronger market positions;
- Insufficient revenues to offset increased expenses associated with acquisitions; and
- Potential loss of key employees of the acquired companies.

Acquisitions may also cause us to:

- Issue common stock that would dilute our current stockholders percentage ownership;
- Assume liabilities;
- Record goodwill and non-amortizable intangible assets that will be subject to impairment testing and potential periodic impairment charges;
- Incur amortization expenses related to certain intangible assets;
- Incur additional expense related to Sarbanes-Oxley compliance;
- Incur large and immediate write-offs of in-process research and development costs; and/or
- Become subject to litigation.

Mergers and acquisitions of high technology companies are inherently risky, and no assurance can be given that our previous or future acquisitions will be successful or will not adversely affect our business, operating results, financial condition or result in material control weaknesses with respect to Sarbanes-Oxley compliance. Failure to manage and successfully integrate acquisitions could harm our business and operating results in a material way. Even when an acquired company has already developed and marketed products, there can be no assurance that product enhancements will be made in a timely fashion or that pre-acquisition due diligence will have identified all possible issues that might arise with respect to such products.

We have not made acquisitions that result in in-process research and development expenses being charged in an individual quarter. These charges may occur in future acquisitions in any particular quarter, resulting in variability in our quarterly earnings.

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Litigation

From time to time, we become involved in litigation claims and disputes in the ordinary course of business. We are currently involved in several lawsuits (see Item 3 Legal Proceedings below). Litigation can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. An unfavorable resolution of a particular lawsuit could have a material adverse effect on our business, operating results, or financial condition.

Protection of Intellectual Property

We rely on a combination of patent, trade secret, copyright, trademark, and contractual provisions to protect our proprietary rights in our software products. There can be no assurance that these protections will be adequate or that competitors will not independently develop technologies that are substantially equivalent or superior to our technology. In addition, copyright and trade secret protection for our products may be unavailable or unreliable in certain foreign countries. As of September 30, 2006, we have been issued 77 patents in the U.S. and had 41 patent applications in process in the United States Patent and Trademark Office. On a worldwide basis, we have been issued 151 patents with respect to our product offerings and have 143 patent applications pending with respect to certain products we market. We maintain an active internal program designed to identify employee inventions worthy of being patented. There can be no assurance that any of the pending applications will be approved and patents issued or that our engineers will be able to develop technologies capable of being patented. Also, as the number of software patents increases, we believe that companies that develop software products may become increasingly subject to infringement claims.

There can be no assurance that a third party will not assert that their patents or other proprietary rights are violated by products offered by us. Any such claims, whether or not meritorious, may be time consuming and expensive to defend, may trigger indemnity obligations owed by us to third parties and may have an adverse effect on our business, results of operations and financial condition. Infringement of valid patents or copyrights or misappropriation of valid trade secrets, whether alleged against us, or our customers, and regardless of whether such claims have merit, could also have an adverse effect on our business, results of operations and financial condition.

Effective Tax Rates

Our future effective tax rates could be adversely affected by earnings being higher or lower than anticipated in jurisdictions where we have varying statutory rates or by changes in tax laws or interpretations thereof.

Entrance into New or Developing Markets

In the event that we focus on new market opportunities, we would be likely to increasingly compete with large, established suppliers as well as start-up companies. Some of our current and potential competitors may have greater resources, including technical and engineering resources, than we have. Additionally, as customers in these markets mature and expand, they may require greater levels of service and support than we have provided in the past. Our efforts to sell applications software for PCs, and to sell CSS as well as software applications for non-PC devices may require us to sell into markets, or to players in those markets, where we do not have significant prior experience and may require us to increase our spending levels for marketing and sales as well as research and development activities. Many of our competitors may have an advantage over us because of their larger presence and deeper experience in these markets. There can be no assurance that we will be able to develop and market products, services, and support to effectively compete for these market opportunities. Further, provision of greater levels of services may result in a delay in the timing of revenue recognition.

Changes in Financial Accounting Standards and Increased Cost of Compliance

We prepare our financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP). GAAP principles are subject to interpretation by the Financial Accounting Standard Board, the American Institute of Certified Public Accountants, the SEC and various bodies appointed by these organizations to interpret existing rules and create new accounting policies. Accounting policies affecting software revenue recognition, in particular, have been the subject of frequent interpretations, which have had a profound effect on the way we license our products. As a result of the enactment of the Sarbanes-Oxley Act in 2002 and the related scrutiny of accounting policies by the SEC and the various national and international accounting industry bodies, we expect the frequency of accounting policy changes as well as the cost of compliance to increase. Future changes in financial accounting standards, including pronouncements relating to revenue recognition, may have a significant effect on our reported results.

Importance of Microsoft and Intel

For a number of years, we have worked closely with leading software and semiconductor companies, including Microsoft and Intel, in developing standards for the PC industry. Although we remain optimistic regarding relationships with these industry leaders, there can be no assurance that they or other software or semiconductor companies will not develop alternative product strategies that could conflict with our product plans and marketing strategies. Action by such companies may adversely impact our business and results of operations.

Intel is the leading semiconductor supplier to the customers of our CSS software products. Intel is developing and promoting software under the product name Tiano that competes with our CSS software products and offers this software at no charge through both custom and open source licenses. Some of our CSS competitors provide services and additional features for the Intel software, and we believe that in return Intel provides them with compensation and promotional benefits. We must continuously create new features and functions to sustain, as well as increase, our software s added value to our customers particularly in light of Intel s initiative. There can be no assurances that we will be successful in these efforts.

Dependence on Key Customers; Concentration of Credit

The loss of any key customer and our inability to replace revenues provided by a key customer may have a material adverse effect on our business and financial condition. Our customer base includes large OEMs in the PC market as well as PC motherboard manufacturers. As a result, we maintain individually significant receivable balances due from some of them. If these customers fail to meet guaranteed minimum royalty payments and other payment obligations, our operating results and financial condition could be adversely affected. As of September 30, 2006, three customers accounted for 12%, 13%, and 20%, respectively, of our total accounts receivable. There are no other customers with more than 10% of our total accounts receivable.

Competition

The markets for our products are intensely competitive and we expect both product and pricing competition to increase. Increased competition could result in pricing pressures, reduced margins, or the failure of one or more of our products to achieve or maintain market acceptance, any of which could adversely affect our business.

The Company competes for CSS sales primarily with in-house R&D departments of PC and component manufacturers that may have significantly greater financial and technical resources, as well as closer engineering ties and experience with specific hardware platforms, than the Company. Major companies that may use their own internal BIOS R&D personnel include Dell Computer Corporation, Hewlett Packard Company, IBM Corporation, Toshiba Corporation and Intel Corporation. In addition, some of these competitors are also our customers. Any inability to effectively manage these complicated relationships with customers and suppliers could have a material adverse effect on our business, operating results and financial condition and accordingly affect our chances of success.

The Company also competes for system software business with other independent suppliers, including American Megatrends Inc., a privately held company, and other BIOS companies.

In the applications software area, as with CSS, the Company competes with in-house and third party company solutions. The Company s applications that reside in the protected area of the hard drive compete with individual component software and diagnostic and repair software from other companies, as well as with PC manufacturer-developed solutions. Large enterprise solution competitors such as Altiris Incorporated and Symantec Corporation, as well as smaller third party companies, are the primary players.

The principal competitive factors in the markets in which we presently compete and may compete in the future include:

- The ability to provide products and services that meet the needs of our target customers;
- The functionality and performance of these products;
- Price;
- The ability to timely introduce new products; and
- Overall company size and perceived stability.

There can be no assurance that we will be successful in our efforts to compete in any markets in which we operate.

International Sales and Activities

Revenues derived from international sales comprise a majority of total revenues. There can be no assurances that we will not experience significant fluctuations in international revenues. Our operations and financial results may be adversely affected by factors associated with international operations, such as changes in foreign currency exchange rates, uncertainties related to regional economic circumstances, unexpected changes in local laws or regulations, political instability in emerging markets, difficulties in attracting qualified employees, and language, cultural and other difficulties managing foreign operations.

In addition, an increasing percentage of our labor force, particularly in engineering, is located in China, Taiwan and India. Approximately 66% or 235 employees are located outside of the U.S. as of November 30, 2006. Although one of our objectives in utilizing employees based in these markets is to ensure a supply of talented employees at lower expense than we incur in our other employee locations, there can be no assurances that a favorable market for employees will continue to exist in any of our foreign locations, or that changes in local conditions, such as labor laws and regulations, will not adversely affect our results of operations.

The Company may in the future choose to terminate the existence of one or more of our foreign operations or subsidiaries. Any such choice may give rise to financial consequences including the possibility of additional taxes or other charges in these jurisdictions or of changes to tax loss carry forwards or credits in these or other jurisdictions.

Volatile Market for Phoenix Stock

The market for our stock is highly volatile. The trading price of our common stock has been, and will continue to be, subject to fluctuations in response to operating and financial results, changes in demand for our products and services, announcements of technological innovations, the introduction and market acceptance of new technologies by us, our competitors, or other industry participants, including the launch of Microsoft s Vista operating system, changes in our product mix or product direction or the product mix or direction of our competitors, pricing pressure from our customers and competitors, changes in our revenue mix and revenue growth rates, changes in expectations of growth for the PC industry or the x86 based non-PC digital device industry, the overall trend toward industry consolidation both among our competitors and customers, the timing and size of orders from customers, our ability to achieve targeted cost reductions, as well as other events or factors which we may not be able to influence or control. Statements or changes in opinions, ratings or earnings estimates made by brokerage firms and industry analysts relating to the markets in which we do business, companies with which we compete or relating to us specifically could have an immediate and adverse effect on the market price of our stock. In addition, the stock market has from time to time experienced extreme price and volume fluctuations that have particularly affected the market price for many small capitalization, high technology companies and have often been triggered by factors other than the operating performance of these companies. If the market value of our stock decreases below our net book value, we may have to record a charge for impairment of goodwill.

Certain Anti-Takeover Effects

Our Certificate of Incorporation, Bylaws and the Delaware General Corporation Law include provisions that may be deemed to have anti-takeover effects and may delay, defer or prevent a takeover attempt that stockholders might consider in their best interests. These include provisions under which members of the Board of Directors are divided into three classes and are elected to serve staggered three-year terms. In addition, in November 1999 and in accordance with the Company s Preferred Shares Rights Agreement, the Company issued as a dividend on its common stock certain rights to purchase the Company s Series B Participating Preferred Stock. These rights are exercisable upon triggering events related to a change of control of the Company, and, upon exercise, would cause immediate substantial dilution of the Company s outstanding common stock. Thus the existence of these rights (also known as a poison pill) could have a deterrent effect on any person or group that is considering acquiring the Company on terms not approved by the Company s Board of Directors.

Business Disruptions

While we have not been the target of software viruses specifically designed to impede the performance of our products, such viruses could be created and deployed against our products in the future. Similarly, experienced computer programmers or hackers may attempt to penetrate our network security or the security of our Web sites from time to time. A hacker who penetrates our network or Web sites could misappropriate proprietary information or cause interruptions of our services. We might be required to expend significant capital and resources to protect against, or to alleviate, problems caused by virus creators and/or hackers. In addition, acts of war, power shortage, natural disasters, acts of terror, and regional and global health risks could impact our ability to conduct business in certain regions. Any of these events could have an adverse effect on our business, results of operations, and financial condition.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The Company leases approximately 86,000 square feet of office space for our headquarters in Milpitas, California under a facility lease that expires in 2013. The Company leases an approximately 49,000 square foot facility in Irvine, California under a lease agreement that expires in 2009. The Company has subleased all of the Irvine facility for the remainder of the lease term. The Company also leases office facilities in other locations including: Norwood, Massachusetts; Beaverton, Oregon; Taipei, Taiwan; Hong Kong; Shanghai, Beijing and Nanjing, China; Tokyo, Japan; Hyderabad, India; and Seoul, Korea. These offices range from small sales offices up to approximately 21,000 square feet of office space and generally provide engineering, sales, and technical support to customers. The lease terms for these facilities expire between 2007 and 2011. In August 2006, the Company closed its office in Shenzhen, China. In addition, in fiscal year 2006, the Company closed or in progress of closing facilities in Munich, Germany, Zaltbommel, the Netherlands, Osaka, Japan, and Rockville, Maryland pursuant to our restructure plans.

The Company considers its leased properties to be in good condition, well maintained, and generally suitable for their present and foreseeable future needs. The Company believes its facilities are adequate for its current needs and that suitable additional or substitute space will be available as needed to accommodate any expansion of its operations.

ITEM 3. LEGAL PROCEEDINGS

The Company is subject to certain routine legal proceedings that arise in the normal course of our business. We believe that the ultimate amount of liability, if any, for pending claims of any type (either alone or combined), including the legal proceedings described below, will not materially affect the Company s results of operations, liquidity, or financial position taken as a whole. However, the ultimate outcome of any litigation is uncertain, and unfavorable outcomes could have a material adverse impact. Regardless of outcome, litigation can have an adverse impact on the Company due to defense costs, diversion of management resources, and other factors.

Digital Development Corp. v. Phoenix Technologies Ltd. and John Does 1-100. On January 4, 2006, Digital Development Corp., a Arizona corporation (DDC) filed a patent infringement action against the Company in the Federal District Court of New Jersey, alleging that certain of our products infringe two U.S. patents (U.S. Patent Nos. 4,975,950 and 5,121,345) owned by DDC. As of the date of this disclosure, the Company has not been served with a complaint in this case and no deadlines for action have been set. The Company does not believe that the case has merit and intends to vigorously defend itself. The Company further believes that risk of loss in this case is remote.

Jablon v. Phoenix Technologies Ltd. On November 7, 2006, David P. Jablon filed a Demand for Arbitration with the American Arbitration Association (under its Commercial Arbitration Rules) pursuant to the arbitration provision of a Stock Purchase Agreement dated February 16, 2001, by and among Phoenix Technologies Ltd., Integrity Sciences, Incorporated (ISI), and David P. Jablon (the ISI Agreement). The Company acquired ISI from Mr. Jablon (the sole shareholder) pursuant to the ISI Agreement. Mr. Jablon has alleged breach of the earn-out provision of the ISI Agreement. The earn-out provision of the Agreement provides that Mr. Jablon will be entitled to receive 50,000 shares of Company common stock in the event certain revenue milestones are achieved from the sale of various security-related products by the Company. The dispute relates to the calculation of achievement of such milestones. As of the date of this disclosure, the Company has not been formally served with the demand for arbitration in this case and no deadlines for action have been set. The Company does not believe that the case has merit and intends to vigorously defend itself. The Company further believes that it is likely to prevail in this case, although other outcomes are possible.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

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PART II

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

The Company s common stock is traded on the NASDAQ Global Market under the symbol PTEC. The following table sets forth, for the periods indicated, the highest and lowest closing sale prices for the Company s common stock, as reported by the NASDAQ Global Market. The closing price of the Company s common stock on November 30, 2006 was $4.85.

	High	**Low**
Year ended September 30, 2006		
Fourth quarter	$ 5.38	$ 4.30
Third quarter	6.56	3.88
Second quarter	7.24	6.28
First quarter	7.53	5.52
Year ended September 30, 2005		
Fourth quarter	$ 8.58	$ 6.36
Third quarter	9.33	7.20
Second quarter	10.24	6.99
First quarter	8.41	5.03

The Company had 183 shareholders of record as of November 30, 2006. To date, the Company has paid no cash dividends on its common stock. The Company currently intends to retain all earnings for use in its business and does not anticipate paying any dividends in the foreseeable future.

On October 11, 2005, the Board of Directors authorized the Company to repurchase up to $15 million of its common stock. In accordance with its terms, the authorization for this repurchase plan expired on October 10, 2006. During fiscal year 2006, the Company repurchased 217,692 shares at a cost of $1.2 million. The following table provides the shares of our common stock repurchased by us during the fiscal year 2006:

Period	Total Number of Shares (or Units) Purchased	Average Price Paid per Share (or Units)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plan or Program	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plan or Program
October 1 - October 31, 2005				$ 15,000,000
November 1 - November 30, 2005				15,000,000
December 1 - December 31, 2005	149,749	$ 6.64	149,749	14,006,221
January 1 - January 31, 2006				14,006,221
February 1 - February 28, 2006				14,006,221
March 1 - March 31, 2006				14,006,221
April 1 - April 30, 2006				14,006,221
May 1 - May 31, 2006	37,943	5.58	37,943	13,792,855
June 1 - June 30, 2006				13,792,855
July 1 - July 31, 2006	30,000 (1)	1.00	30,000	13,764,395
August 1 - August 31, 2006				13,764,395
September 1 - September 30, 2006				13,764,395
Total	217,692	$ 13.22	217,692	$ 13,764,395 (2)

(1) The Company repurchased 30,000 shares of common stock at a price of $1.00 per share, in accordance with the restricted stock agreements during the fourth quarter of fiscal year 2006. These shares were owned by executive officers who are no longer employed by the Company.

(2) In accordance with its terms, the repurchase program approved by the Board of Directors on October 11, 2005 expired on October 10, 2006.

ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The financial data set forth below should be read in conjunction with our consolidated financial statements and related notes thereto in Item 8 Financial Statements and Supplementary Data and Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations. The results of operations for any period are not necessarily indicative of the results to be expected for any future period and may vary because of a number of factors, including those set forth under Item 1A Risk Factors and elsewhere in this Form 10-K *(in thousands, except per share data)*.

Consolidated Statements of Operations Data

	For the Years ended September 30, 2006	2005	2004	2003	2002
Revenues	$ 60,495	$ 99,536	$ 86,750	$ 85,408	$ 93,080
Gross margin	42,585	82,083	71,558	68,238	79,173
Operating Income (loss) from continuing operations	(42,182)	9,541	3,064	(15,121)	(5,620)
Income (loss) from continuing operations	(43,969)	277	449	(26,654)	(3,320)
Discontinued operations, net of tax					(1,570)
Net income (loss)	(43,969)	277	449	(26,654)	(4,890)
Earnings (loss) per share from continuing operations:					
Basic	$ (1.74)	$ 0.01	$ 0.02	$ (1.09)	$ (0.13)
Diluted	$ (1.74)	$ 0.01	$ 0.02	$ (1.09)	$ (0.13)
Earnings (loss) per share:					
Basic	$ (1.74)	$ 0.01	$ 0.02	$ (1.09)	$ (0.19)
Diluted	$ (1.74)	$ 0.01	$ 0.02	$ (1.09)	$ (0.19)

Consolidated Balance Sheet Data

	September 30, 2006	2005	2004	2003	2002
Cash, cash equivalents, and marketable securities	$ 60,331	$ 74,827	$ 59,823	$ 47,246	$ 76,312
Working capital	42,495	74,348	65,696	55,172	71,495
Total assets	95,160	131,036	120,885	116,463	153,286
Long-term obligations	4,551	4,205	3,590	2,464	726
Stockholders equity	60,176	96,964	93,029	91,391	125,957

In January 2002, the Company acquired certain assets of a privately held company, StorageSoft, Inc. (StorageSoft), pursuant to an Asset Acquisition Agreement dated December 21, 2001. StorageSoft is a developer of drive diagnostic utilities and hard drive imaging software that reduces the cost to own, deploy, and manage multiple PCs. This acquisition was accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired business were included in the Consolidated Balance Sheets as of September 30, 2002. The results of operations from the date of acquisition through September 30, 2002 were included in the accompanying Consolidated Statement of Operations for the year ended September 30, 2002.

In the fourth quarter of fiscal year 2002, the Company completed the sale of inSilicon. Fiscal year 2002 results have been reclassified to reflect inSilicon as discontinued operations.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Form 10-K. The following discussion contains forward-looking statements based upon current expectations that involve risks and uncertainties. Our actual results may differ materially from those indicated in such forward-looking statements as a result of a number of factors, including those set forth under Item 1A Risk Factors and elsewhere in this Form 10-K.

Company Overview

We design, develop and support core system software for personal computers and other computing devices. Our products, which are commonly referred to as firmware, support and enable the compatibility, connectivity, security, and manageability of the various components and technologies used in such devices. We sell these products primarily to computer and component device manufacturers. We also provide training, consulting, maintenance and engineering services to our customers.

The majority of the Company s revenue comes from Core System Software (CSS), the modern form of BIOS (Basic Input-Output System), for personal computers, servers and embedded devices. Our CSS customers are primarily original equipment manufacturers (OEMs) and original design manufacturers (ODMs), who build in CSS products during the manufacturing process. The CSS is typically stored in non-volatile memory on a chip that resides on the motherboard built into the device. The CSS is executed during the power up in order to test, initialize and manage the functionality of the device s hardware. Our CSS products are incorporated in over 100 million devices per year, giving us global market share leadership in this sector.

The Company also licenses software developer kits (SDKs) to qualified partners for the development of core-resident, integrated, value-add software applications built on our CSS platform. These partners, including independent software vendors, independent hardware vendors, OEMs, ODMs, system integrators, and system builders, can build and deploy applications in categories such as utilities, productivity, security, and content delivery using our development tools.

The Company has developed and markets a family of software application products that restore a device s data, enable device identification to a network, and provide instant-on access to certain frequently used applications. Although the true end-users of these applications products are enterprises, governments and service providers, we typically sell these solutions as firmware to OEMs and ODMs to assist them in making their products attractive to those end-users.

Finally, the Company derives additional revenue from providing support services such as training, maintenance and engineering expertise to our software customers.

Historically we have analyzed revenue along two dimensions:

1. Platform, with PCs and servers representing one category and non-PC devices, including consumer and industrial devices, representing a second category.

2. Products, with CSS representing one category and software applications representing the second category.

We disclose revenue breakdowns in three resulting sectors which will be discussed in more detail under *Results of Operations* and *Revenues* .

1. PC/Server Core System Software

2. PC/Server Applications

3. Non-PC Devices (including both CSS and applications)

Fiscal Year 2006 Overview

Total revenues for fiscal year 2006 decreased by $39.0 million or 39.2%, from $99.5 million in fiscal year 2005 to $60.5 million in fiscal year 2006. A substantial portion of the decline occurred in the second half of the fiscal year, when revenues were only $18.8 million, down 59.4% from $46.3 million in the second half of fiscal year 2005 and 54.9% from $41.7 million for the first half of fiscal year 2006.

The decrease in revenues is partially attributable to the effect of the Company s having sold increasing proportions of its products through the use of fully paid-up licenses during fiscal years 2004 and 2005 and the first half of fiscal year 2006. These paid-up licenses gave customers unlimited distribution rights of the applicable product over a specific time period or with respect to a specific customer device. In connection with paid-up licenses, the Company recognizes all license revenues upon execution of the agreement provided that all other revenue recognition criteria are met. Paid-up license agreements may have the effect of accelerating revenue into the quarter in which the agreement is executed and thereby decreasing recurring revenues in later periods. Total paid-up license revenue for all sectors represented 18% of total revenues (or $15.6 million) in fiscal year 2004, 43% of total revenues (or $43.0 million) in fiscal year 2005 and 62% of total revenues (or $25.7 million) in the first half of fiscal year 2006.

During the third quarter of fiscal year 2006, we began changing our licensing practices away from heavy reliance on paid-up licenses to volume purchase agreements for large customers and pay-as-you-go royalty-based arrangements with smaller customers. Paid up licenses constituted only 25% of total revenues (or $4.8 million) in the second half of fiscal year 2006 and we ended the use of paid-up licenses in September 2006. For the full fiscal year, paid-up licenses amounted to $30.5 million or 50% of total revenues.

Gross margins declined substantially, from 83% of revenues in fiscal year 2005 to 70% of revenues in fiscal year 2006. This decline was principally the result of the costs of delivering our products and services remaining relatively unchanged even though revenues declined materially.

All categories of operating expense also increased materially as a percentage of revenue as shown in the table below principally as a result of the revenue decline.

The company incurred a net loss of $44.0 million in fiscal year 2006, which compared to net income of $0.3 million in fiscal year 2005. These losses were principally attributable to the revenue decline discussed above. Substantial management changes were made during the year, including the appointment of a new Chief Executive Officer during September 2006. In the second half of the fiscal year (and continuing into the first quarter of fiscal year 2007) the Company announced a series of restructuring initiatives designed to materially reduce operating expenses. In September 2006 the Company also announced the cessation of its efforts to sell application products to enterprise customers.

Results of Operations

The following table includes Consolidated Statements of Operations data for the years ended September 30, 2006, 2005, and 2004 as a percentage of total revenues:

	2006	2005	2004
Revenues:			
License and service fees	100 %	100 %	100 %
Total revenues	100	100	100
Cost of revenues:			
License and service fees	25	14	13
Amortization of purchased technology	5	3	4
Total cost of revenues	30	17	17
Gross margin	70	83	83
Operating expenses:			
Research and development	38	20	26
Sales and marketing	59	36	38
General and administrative	36	17	15
Restructuring cost	8		
Total operating expenses	140	73	79
Operating income (loss) from continuing operations	-70	10	4
Interest and other income, net	3		
Income (loss) before income taxes	-67	10	4
Income tax expense	6	10	3
Net income (loss)	-73 %	0 %	1 %

Revenues

Revenues by geographic region based on country of sale for fiscal years 2006, 2005, and 2004 were as follows (*in thousands, except percentages*):

	Amount of Revenues			% Change from Previous Year		% of Revenues		
	2006	2005	2004	2006	2005	2006	2005	2004
North America	$ 6,384	$ 24,852	$ 16,342	-74.3 %	52.1 %	10.6 %	25.0 %	18.8 %
Japan	18,302	21,803	29,034	-16.1	-24.9	30.3	21.9	33.5
Taiwan	28,556	36,608	31,044	-22.0	17.9	47.2	36.8	35.8
Other Asian Countries	5,089	8,233	4,294	-38.2	91.7	8.4	8.3	4.9
Europe	2,164	8,040	6,036	-73.1	33.2	3.5	8.0	7.0
Total Revenues	$ 60,495	$ 99,536	$ 86,750	-39.2 %	14.7 %	100.0 %	100.0 %	100.0 %

Total revenues in fiscal year 2006 decreased by $39.0 million or 39.2% compared with fiscal year 2005. Revenues for fiscal year 2006 decreased in all geographic areas primarily due to a decreased reliance on the use of paid-up licenses in fiscal year 2006 as compared to fiscal year 2005. The declines were greatest in North America and Europe, which declined 74.3% and 73.1% respectively, primarily due to a number of large paid-up license arrangements which were entered into in fiscal year 2005. The declines incurred in Japan, Taiwan and other Asian countries were 16.1%, 22%, and 38.2% respectively and related primarily to the use of paid-up licenses in earlier periods.

Total revenues in fiscal year 2005 increased by $12.8 million or 14.7% compared with fiscal year 2004. Revenues for fiscal year 2005 from Japan decreased by 24.9%, while revenues from Taiwan, Other Asian Countries, North America, and Europe increased by 17.9%, 91.7%, 52.1%, and 33.2% respectively, from

fiscal year 2004. The decrease in Japan was primarily due to the continued migration of system manufacturing from OEMs in Japan to ODMs primarily based in Other Asian Countries that generally ship in higher volumes and at lower unit prices. The increase in revenue in Taiwan, Other Asian Countries, North America, and Europe was primarily due to 1) increased unit shipments as a result of general industry expansion as well as our increased market share in the CSS sector, and 2) a number of large paid-up license arrangements that we entered into in fiscal year 2005, under which all revenues were recognized up-front. Total revenues from paid-up licenses in 2005 and 2004 represented approximately $43.0 million, or 43%, and $15.6 million, or 18%, of overall revenues in such respective years.

The following table represents revenue by sector for fiscal years 2006, 2005 and 2004 *(in thousands, except percentages):*

	Years ended September 30,			**% of Revenues**		
	2006	**2005**	**2004**	**2006**	**2005**	**2004**
PC/Server Core System Software	$ 40,016	$ 64,492	$ 62,100	66.1 %	64.8 %	71.6 %
PC/Server Applications	9,683	19,165	8,283	16.0 %	19.3 %	9.5 %
Non PC Core System Software and Applications	10,796	15,879	16,367	17.9 %	15.9 %	18.9 %
Total	$ 60,495	$ 99,536	$ 86,750	100.0 %	100.0 %	100.0 %

The PC/Server Core System Software sector revenues were $40.0 million in fiscal year 2006, or 66% of total revenues, as compared to $64.5 million in fiscal year 2005, or 65% of total revenues. The 38% decrease in PC/Server Core System Software revenues was principally attributable to the Company s use of paid-up software licenses during earlier periods. For the PC/Core System Software sector, revenue from paid-up licenses represented $20.8 million or 34% of fiscal year 2006 revenue compared to $30.6 million or 31% of fiscal year 2005 revenue.

PC/Server Core System Software revenues were $64.5 million in fiscal year 2005, or 65% of total revenues, as compared to $62.1 million in fiscal year 2004, or 72% of total revenues. The increase in fiscal year 2005 revenue in this sector was attributable to multiple factors including increased unit shipments as a result of a modest increase in overall PC industry unit volume and a continuing shift in PC demand from desktops to notebooks, for which our unit price is higher. These favorable factors were partially offset by continuing downward pressure on the prices of all components of PCs, which has been a long-term trend. Revenues in this sector also benefited from an increased number of large paid-up license arrangements in fiscal year 2005, as revenues related to such paid-up arrangements increased from $9.9 million in fiscal 2004 to $30.6 million in fiscal year 2005.

PC/Server Applications revenues were $9.7 million in fiscal year 2006, or 16% of total revenues, as compared to $19.2 million for fiscal year 2005, or 19% of total revenues. The 49% decrease in the PC/Server Application software sector was attributable to several factors. First, revenue from the sale of our Always product decreased from $13.0 million in fiscal year 2005 to $0.3 million; this decrease relates to our entry into a number of large contracts in 2005 and a subsequent reduction in demand in 2006. The decrease in demand for the Always product was offset in part by increased revenue from the Recover Pro products. Additionally, PC/Server Applications revenues were negatively impacted by our decreased use of paid-up licenses in fiscal year 2006 as revenues in this sector from paid-up licenses were $5.8 million in fiscal year 2006, or 10% of total revenue, as compared to $8.2 million in fiscal year 2005, or 8% of total revenue. In September 2006, we ended our use of paid-up licenses.

For the majority of fiscal year 2006, we were allocating considerable resources towards the development of a reseller channel for our PC/Server Applications products with the expectation that our channel partners would assist us in selling these products to enterprises, governments and service providers. During the fourth quarter of fiscal year 2006, due to high costs incurred in selling our products in the enterprise market, we decided to refocus our application products sales, marketing and development efforts so as to concentrate primarily on sales to the PC and component manufacturers rather than continuing with the channel sales initiatives.

PC/Server Applications revenues were $19.2 million in fiscal year 2005, or 19% of total revenues, as compared to $8.3 million for fiscal year 2004, or 10% of total revenues. Revenues from paid-up license arrangements in this revenue sector increased to $8.2 million in fiscal year 2005 from $0.5 million in fiscal year 2004. However, the majority of this amount in fiscal year 2005 came from transactions with OEMs where the principal focus of the paid-up license was CSS products; in such cases we allocate revenues between PC/Server Core System Software and PC/Server Applications as discussed below under Critical Accounting Policies and Estimates . A number of our software applications products, including Recover Pro, TrustConnector, and Firstware Assistant, were introduced in their current architecture in mid- to late fiscal year 2004, and consequently did not contribute significantly to revenues until fiscal year 2005. Also, the company continued to make progress in increasing the range of our applications products available in the market through significant investments in new reseller, distribution, and system builder channels. As sales into designs originating from these channels tend to follow a much longer life cycle, we believe that the growth in total PC/Server Applications revenues demonstrates our success in securing new system designs and strengthening our relationships with our customers as they roll out their products.

The Non-PC Device sector revenues decreased to $10.8 million in fiscal year 2006, or 18% of total revenues, from $15.9 million in fiscal year 2005, or 16% of total revenues. The decrease is primarily related to our reduced usage of paid-up licenses as of the third quarter of fiscal year 2006 relative to our heavy reliance on such paid-up licenses in the previous two years.

Non-PC Device revenues, which includes both Core System Software and software applications decreased slightly to $15.9 million in fiscal year 2005, or 16% of total revenues, from $16.4 million in fiscal year 2004, or 19% of total revenues. Revenues from paid-up license arrangements in this revenue sector decreased to $4.2 million in fiscal year 2005 from $6.4 million in fiscal year 2004. The overall $15.9 million result was less than our internal expectations because we were less effective than we hoped to be at building sales and distribution channels for our products in the Non-PC Device sector, and at delivering additional product features relevant to this sector.

Cost of Revenues and Gross Margin

Cost of revenues consists of third party license costs, service costs and amortization of purchased technology. License costs are primarily third party royalty fees as well as product fulfillment costs such as product media, duplication, labels, manuals, packing supplies and shipping costs. Service costs include personnel-related expenses such as salaries and other related costs associated with work performed under professional service contracts and non-recurring engineering agreements as well as post-sales customer support costs. License costs tend to be variable based on license revenue volumes, whereas service costs tend to be fixed within certain service revenue volume ranges.

Cost of revenues increased by 3%, or $0.5 million, in fiscal year 2006 compared to fiscal year 2005. License fees increased by $0.4 million in fiscal year 2006 over fiscal year 2005. Cost of revenues also increased due to stock based compensation expense of approximately $0.3 million which the Company began expensing in fiscal year 2006 pursuant to SFAS No. 123(R). These increases in cost of revenues were offset by lower amortization of purchased technology of $0.2 million in fiscal year 2006 as compared to fiscal year 2005.

Cost of revenues increased 15%, or by $2.3 million, in fiscal year 2005 compared to fiscal year 2004, primarily as a result of increased investment in our post-sales customer support teams.

Gross margin as a percentage of revenues was 70%, 83%, and 83% for fiscal years 2006, 2005, and 2004. Gross margin was $42.6 million for fiscal year 2006 as compared to $82.1 million in fiscal year 2005 and $71.6 million in fiscal year 2004. The decrease in the gross margin percentage in fiscal year 2006 compared to fiscal year 2005 is due to lower total revenues as our cost of revenues are relatively fixed. The increase in gross margin (with a stable gross margin percentage) in fiscal year 2005 versus fiscal year 2004 was mainly related to higher revenues offset in part by increased investment in our post-sales customer support teams. Amortization of purchased technologies from business combinations was $3.1 million, $3.4 million, and $3.4 million for the fiscal years 2006, 2005, and 2004, respectively.

Research and Development Expenses

Research and development expenses consist primarily of salaries and other related costs for research and development personnel, quality assurance personnel, product localization expense, fees to outside contractors, facilities and IT support costs as well as depreciation of capital equipment. Research and development expenses were $22.9 million, $20.4 million, and $22.4 million in fiscal years 2006, 2005, and 2004, and as a percentage of revenues, these expenses represent 38%, 20%, and 26%, respectively.

The $2.5 million or 12% increase in research and development expense in fiscal year 2006 compared to 2005 was due to number of factors including: increased payroll and related benefit expenses of approximately $0.6 million, which is primarily related to additional headcount outside the U.S., stock based compensation expense of $0.9 million which the Company began expensing in fiscal year 2006 pursuant to SFAS No. 123(R), increased spending for consulting related to new application products of $0.5 million and a net increase in other expense items of approximately $0.4 million.

The $2.0 million decrease in research and development expenses in fiscal year 2005 from fiscal year 2004 was primarily due to lower payroll and related expenses resulting from the Company s shift of research and development activity to lower-cost manufacturing centers in China and India throughout fiscal year 2005.

Sales and Marketing Expenses

Sales and marketing expenses consist primarily of salaries, commissions, travel and entertainment, facilities and IT support costs, promotional expenses (marketing and sales literature) and marketing programs including advertising, trade shows and channel development. Sales and marketing expenses also include costs relating to technical support personnel associated with pre-sales activities such as performing product and technical presentations and answering customers product and service inquiries.

Sales and marketing expenses were $35.4 million, $35.6 million, and $32.8 million in fiscal years 2006, 2005, and 2004 and as a percentage of revenues, these expenses represent 59%, 36%, and 38% in fiscal years 2006, 2005, and 2004, respectively.

The $0.2 million net decrease in sales and marketing spending in fiscal year 2006 from fiscal year 2005 was primarily due to a number of factors including: decreased commissions of $1.5 million due to overall lower revenues, lower spending on travel and entertainment of $0.3 million, lower outside recruiting expense of $0.3 million, a net decrease in other expense items of approximately $0.5 million, and lower facilities costs and IT support costs of $0.6 million. These reductions in spending were nearly entirely offset by increased spending for marketing programs related to enterprise applications of $1.1 million as well as stock based compensation expense of $1.9 million, which the Company began expensing in fiscal year 2006 pursuant to SFAS No. 123(R).

The $2.9 million or 9% increase in sales and marketing expense in fiscal year 2005 compared to fiscal year 2004 was primarily driven by higher payroll and related commissions and selling expenses and increased investment in sales and marketing programs, all of which were related to our efforts to increase sales and marketing headcount across all regions and enhance our distribution and reseller channel building efforts.

General and Administrative Expenses

General and administrative expenses consist primarily of salaries and other costs relating to administrative, executive and financial personnel and outside professional fees such as audit and legal.

General and administrative expenses were $21.5 million, $16.4 million, and $13.3 million in fiscal years 2006, 2005, and 2004 and as a percentage of revenues, these expenses represented 36%, 17%, and 15% of total revenue for each such year, respectively. General and administrative expense increased by $5.0 million or 31% in fiscal year 2006 over fiscal year 2005 due to a number of factors including: $0.9 million of severance and related costs for our former Chairman and CEO, $1.7 million of stock based compensation expense related to our adoption of SFAS No. 123(R) effective as of October 1, 2005, and $1.9 million of increased auditing and consulting fees related principally to complying with the reporting requirements under the Sarbanes-Oxley Act of 2002. Additionally, recruiting expenses increased by $0.3 million related to the addition of a new CEO and CFO, our bad debt expense increased by $0.2 million, business taxes related to China increased by $0.3 million, and other items amounted to an additional increase of $0.2 million. These increases in expenses were offset in part by a reduction of $0.5 million in depreciation expense on equipment.

The $3.1 million or 23% increase in general and administrative expenses in fiscal year 2005 compared to fiscal year 2004 was primarily related to an increase of approximately $2.0 million in audit and consulting fees related to complying with the new reporting requirements under the Sarbanes-Oxley Act of 2002, increased legal fees of approximately $0.5 million and increased salaries and related expense for additional new hires of approximately $0.8 million. These expense increases were offset in part by a net decrease in other expenses of $0.2 million.

Restructuring Costs

Restructuring charges/(credits) during fiscal years 2006, 2005, and 2004, were $4.6 million, nil, and ($0.1) million, respectively.

Fiscal Year 2006 Restructuring Plans

In fiscal year 2006, we implemented a number of cost reduction plans in order to reduce costs which were not integral to our overall strategy and to better align our expense levels with our anticipated revenues.

In the fourth quarter of fiscal year 2006, management approved a restructuring plan designed to reduce operating expenses by eliminating 68 positions. In connection with this plan, the Company recorded $2.2 million of employee severance costs. In addition the Company expects to incur an additional restructuring charge of approximately $0.3 million during the first quarter of fiscal year 2007 relating to the closing of its facilities in Zaltbommel, the Netherlands. In the third quarter of fiscal year 2006, management approved a restructuring plan designed to reduce operating expenses by eliminating 35 positions and closing facilities in Munich, Germany and Osaka, Japan. In connection with this plan, the Company recorded $1.8 million of employee severance costs and $0.2 million of facility closure costs. These restructuring costs were accounted for under SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146) and are included in the Company s results of operations. Through September 30, 2006, the Company paid approximately $1.4 million of the costs associated with these restructuring plans. See Note 13 to our Consolidated Financial Statements for further information on the fiscal year 2007 restructuring plan.

Fiscal Year 2003 Restructuring Plan

In the first quarter of fiscal year 2003, the Company announced a restructuring program that affected approximately 100 positions across all business functions and closed its facilities in Irvine, California and Louisville, Colorado. This restructuring resulted in employee termination benefit charges of $2.9 million, estimated facilities exit expenses of $2.5 million, and asset write-offs in the amount of $0.1 million. All charges were recorded in the three months ended December 31, 2002 in accordance with Emerging Issues Task Force 94-3 *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity* (EITF 94-3). As of September 30, 2003, payments relating to the employee termination benefits were completed. Actual payments for employee termination benefits were lower than the original provision as of September 30, 2003. As a result, $0.1 million of excess accrual was reversed in the fourth quarter of fiscal year 2004. In addition, the Company increased the restructuring liability related to the Irvine, California facility by $1.7 million, $0.1 million, and $0.2 million in the fourth quarter of fiscal year 2003, the second quarter of fiscal year 2004, and the third quarter of fiscal year 2004, respectively, to reflect changes in the assumptions made previously for both the length of time the space would remain vacant and the expected sublease rate. In the fourth quarter of fiscal year 2004, the Company decreased the restructuring liability related to the Irvine, California facility by $0.2 million, to reflect sublease activity. In the fourth quarter of fiscal year 2006, the Company increased the restructuring liability related to the Irvine, California facility by $0.5 million, to reflect increased estimated building operating expenses. The unpaid portion of $1.7 million for facilities exit expenses are included under the captions Accrued restructuring charges current and Accrued restructuring charges noncurrent in the Consolidated Balance Sheets. The Irvine lease expires April 2009.

Interest and Other Income, Net

Net interest and other income were $1.9 million, $0.3 million, and $0.2 million in fiscal years 2006, 2005, and 2004, respectively. Net interest and other income consists mostly of interest income, which is primarily derived from cash, cash equivalents and marketable securities, realized and unrealized foreign exchange transaction gains and losses, and losses on disposal of assets.

The interest income generated each period is highly dependent on available cash and fluctuations in interest rates. The average interest rate earned was approximately 4.7%, 3.1%, and 1.5% for fiscal years 2006, 2005, and 2004, respectively. All cash equivalents and marketable securities are U.S. dollar denominated. In fiscal year 2006, we invested mostly in highly liquid short-term marketable securities such as U.S. government and municipal bonds, taxable auction rate preferred instruments and corporate notes. Interest income was $2.8 million, $1.4 million, and $0.6 million in fiscal years 2006, 2005 and 2004, respectively.

Net losses on currency conversions were approximately $0.8 million, $1.0 million and $0.1 million, respectively, in fiscal years 2006, 2005 and 2004 while net loss on disposal of assets was nil, nil, and $0.3 million, in fiscal years 2006, 2005 and 2004, respectively.

Income Tax Expense

The Company recorded income tax provisions of $3.7 million, $9.6 million, and $2.8 million reflecting effective tax rates of (9.1%), 97.2%, and 86.2% in fiscal 2006, 2005, and 2004, respectively and representing primarily foreign withholding taxes in Taiwan, state franchise taxes and estimated taxes related to operations of foreign subsidiaries.

The effective tax rate in fiscal year 2006 was significantly different from the expected tax benefit derived by applying the U.S. federal statutory rate to income before taxes, primarily due to foreign income taxes and withholding taxes assessed by foreign jurisdictions. During the year ended September 30, 2006, the Company recorded a tax expense of $3.7 million of which $3.2 million related to the combination of Taiwan withholding tax and an increase in the tax accrual for a potential Taiwanese transfer pricing adjustment.

The Company believes that the Taiwan Tax Authorities interpretation of the governing law related to transfer pricing is inappropriate and plans to contest an assessment the Company has received in this connection, however there can be no reasonable assurance as to the ultimate outcome. The Company has therefore accrued but not paid the amount of the potential Taiwanese tax liability related to the transfer pricing adjustment. As of the September 30, 2006 the balance of this reserve was $7.6 million.

The Company is not recording a benefit for any deferred tax assets generated in the fiscal year ended September 30, 2006. Deferred tax assets, which relate to both U.S. and foreign taxes and tax credits, amount to $42.7 million at September 30, 2006 but have been offset by a full valuation allowance placed against them.

The effective tax rate in 2005 was significantly different from the expected tax benefit derived by applying the U.S. federal statutory rate to the income before taxes primarily due to foreign income taxes, foreign withholding taxes, and an addition of $6.9 million to the reserve established for the Taiwanese transfer-pricing adjustment exposure.

The effective tax rate in 2004 was significantly different from the expected tax benefit derived by applying the U.S. federal statutory rate to income before taxes, primarily due to the Company reviewing its deferred tax assets and deciding to place a valuation reserve against these assets.

Financial Condition

At September 30, 2006, our principal source of liquidity consisted of cash, cash equivalents and marketable securities totaling $60.3 million, compared to $74.8 million at September 30, 2005. We invest our excess cash in high quality investment grade fixed income securities that are highly liquid.

Net cash used in operating activities in fiscal year 2006 was $13.8 million, which was due primarily to our net loss of $44.0 million, offset by the decrease in accounts receivable by $14.4 million, a decrease in other working capital items of approximately $5.0 million and non-cash items of depreciation and amortization and stock based compensation expense of $6.0 million and $4.8 million respectively.

Cash flows provided from investing activities for fiscal year 2006 were $18.7 million, which were primarily due to proceeds from the sale of marketable securities net of purchases of approximately $21.4 million, offset in part by equipment purchases of $2.2 million and a final payment of $0.5 million in connection with our 2001 acquisition of ISI.

Cash flows provided from financing activities during fiscal year 2006 were $2.0 million, related to $3.2 million of proceeds from the exercise of stock options and purchases under the Employee Stock Purchase Plan, offset by common stock repurchases of $1.2 million.

We reported $27.8 million of consolidated cash and cash equivalents as of September 30, 2005 and $47.0 million of marketable securities.

Net cash provided by continuing operating activities during fiscal year 2005 was $15.8 million, which was due primarily to net income of $0.3 million and the non-cash items of depreciation and amortization and stock based compensation expense of $6.5 million and $0.2 million. Other sources of cash were accounts receivable, prepaid royalties, other assets and income taxes which increased by $1.3 million,

$2.3 million, $1.3 million and $4.4 million, which increases were offset by a net decrease in other working capital items of approximately $0.4 million.

Net cash used in investing activities in fiscal year 2005 was $24.7 million, consisting primarily of $21.1 million in net purchases of marketable securities and $3.1 million in equipment purchases. Net cash provided by financing activities during fiscal year 2005 was $2.7 million, consisting primarily of the exercise of common stock and issuance of stock under our employee stock option and stock purchase plans.

We believe that our current cash and cash equivalents, marketable securities and cash available from future operations will be sufficient to meet our operating and capital requirements for at least the next twelve months. We anticipate that we will incur a net loss in fiscal year 2007 and also expect to incur a negative net cash flow in fiscal year 2007, primarily related to expected reductions in revenues and to severance and other restructuring related costs.

Stock Repurchase Program

In October 2005, the Board of Directors authorized the Company to repurchase up to $15 million of the Company s common stock. In accordance with its terms, the authorization for this repurchase plan expired on October 10, 2006. During fiscal year 2006, the Company repurchased 217,692 shares of its common stock at a cost of $1.2 million.

During fiscal years 2005 and 2004, the Company did not repurchase any shares of its common stock.

Commitments

We have commitments for $16.8 million under non-cancelable operating leases ranging from one to ten years. The operating lease obligations include a net lease commitment for the Irvine, California location of $1.7 million, after sublease income of $1.7 million. The Irvine net lease commitment was included in the Company s fiscal year 2003 first quarter restructuring plan.

On September 30, 2006, our future commitments were as follows *(in thousands)*:

Payments due by period