

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") comments on the consolidated operations, performance and financial condition of MKS Inc. ("MKS" or the "Company") for the three and nine months ended January 31, 2010 and January 31, 2009.

This MD&A should be read in conjunction with the unaudited consolidated financial statements of the Company and the related notes for the three and nine months ended January 31, 2010. All currency amounts in this MD&A are stated in US dollars, unless otherwise indicated.

The financial information set forth in this MD&A has been derived from the unaudited consolidated financial statements of MKS prepared in accordance with United States generally accepted accounting principles ("US GAAP").

Additional information relating to the Company, including the Annual Report and Annual Information Form, is available on SEDAR at [www.sedar.com](http://www.sedar.com).

The date of this MD&A is February 22, 2010.

### Forward Looking Statements

Except for the historical information contained herein, the discussion in this MD&A contains certain forward-looking statements that involve risks and uncertainties, such as statements regarding the Company's plans, objectives, strategies, expectations and intentions. The words "may", "would", "could", "will", "intend", "plan", "anticipate", "believe", "estimate", "expect" and similar expressions, as they relate to the Company or its management, are intended to identify such forward-looking statements. Such statements reflect the Company's views as at the date of this MD&A with respect to future events and are subject to certain risks, uncertainties and assumptions.

Many factors could cause the Company's actual results, performance or achievements to be materially different from any future results, performance or achievements that may be expressed or implied by such forward-looking statements. These factors include, but are not limited to, development of the ALM market, economic uncertainty, currency exchange rate fluctuations, fluctuations in quarterly results, intense competition, management of growth, rapid technological change, dependence on and retention of management and key employees, importance of maintenance contracts, international sales, dependence on a limited number of products, acquisitions, distribution channels in the interoperability market, potential for undetected errors in software, protection of intellectual property, reliance on third party relationships, use of open source software, litigation, concentration of ownership and market maturity in the interoperability market. See the "Risk Factors" section of this MD&A for more detailed information regarding these risks and uncertainties. Although the Company believes the expectations represented by such forward-looking statements are reasonable, there can be no assurance that those expectations will prove to be correct. Should one or more of these risks or uncertainties materialize, or should assumptions underlying the forward-looking statements prove incorrect, actual results may vary materially from those described herein as intended, planned, anticipated, believed, estimated or expected. The Company does not intend, and does not assume any obligation, to update these forward-looking statements, except as required by law.

### About the Company

MKS evaluates operational performance based on two operating segments: application lifecycle management ("ALM") and systems administration ("Interoperability" or "IO"). These segments are managed separately, as each segment requires a unique marketing strategy, and is exposed to different economic environments.

The Company's primary focus is the ALM segment. ALM encompasses the management of all the activities and the artifacts that relate to or impact custom or packaged software applications, including Requirements Management, System Design, Software Configuration Management, Change Management, Test Management and Release Management and the integration and control over a diverse array of software design, modeling and testing tools.

MKS Integrity™ is an enterprise ALM platform that provides consistent capabilities across all disciplines of the application lifecycle by defining hierarchies, relationships and change management processes for numerous user defined application artifacts. Unlike other ALM offerings that have been assembled by acquisition, MKS Integrity is a unified platform providing enterprise class scalability and multi-platform capability to support large-scale software re-use initiatives, workflow-based collaboration, rich mining of application activity data to deliver higher team productivity, visibility and compliance for software engineering and IT organizations.

MKS focuses its marketing and sales efforts on enterprises with large software development organizations. Increasingly, the Company is targeting corporations that deliver software within their products such as software vendors and electronics, automotive and defense companies and systems integration companies. The Company also markets to the software development departments of major corporations that use internally developed applications to run their businesses, such as banks and pharmaceutical and telecommunications companies.

The MKS Interoperability segment encompasses products, namely MKS Toolkit®, which address the issues surrounding UNIX-Windows operating system co-existence, cross-platform development, application migration, systems administration and network management.

### Performance Highlights

Overall, in the third quarter of fiscal 2010 total revenue increased 16% compared to the third quarter of fiscal 2009. Total revenue in the Company's ALM segment increased 15% and total revenue in the IO segment increased 20% from the third quarter of fiscal 2009 to the third quarter of fiscal 2010. License, maintenance and service revenue increased by 34%, 11% and 3%, respectively, for the three months ended January 31, 2010 compared with the three months ended January 31, 2009.

On a year to date basis, total revenue increased 2% in the nine months ended January 31, 2010 compared with the nine months ended January 31, 2009. In the ALM segment, total revenue for the year to date period ending January 31, 2010 increased 4% from the same period ending January 31, 2009.

Operating margin for the Company increased in the third quarter of fiscal 2010 to \$1.7 million, a \$1.3 million improvement from the \$0.4 million in the third quarter of fiscal 2009. Total operating costs for the three months ended January 31, 2010 increased \$0.8 million compared to the three months ended January 31, 2009. On a year to date basis, operating margin increased \$2.7 million in fiscal 2010 compared with fiscal 2009 on the strength of a 4% reduction in operating costs over those periods.

The Company reported a net income of \$1.1 million for the three months ended January 31, 2010, compared with \$0.3 million for the three months ended January 31, 2009. On a year to date basis, net income for the nine months ended January 31, 2010 was \$4.1 million compared with \$2.3 million for the nine months ended January 31, 2009. Headcount for the Company was 321 at January 31, 2010, compared with 314 at January 31, 2009 and 309 at April 30, 2009.

The volume of license, initial maintenance and service transactions over \$100,000 in the third quarter of fiscal 2010 increased to 19 transactions, compared with 12 transactions in the third quarter of fiscal 2009. Of the transactions over \$100,000 in the third quarter of fiscal 2010, there were two transactions over \$500,000, compared with none in the third quarter of fiscal 2009. The increase in revenue from these types of transactions can be attributed to the increase in license transactions over \$100,000.

The Company experienced sharp declines in license revenue in the late fall of 2008 as customers in the automotive, manufacturing and banking sectors, in particular, made drastic reductions in capital spending. Except for a large transaction in the first quarter of fiscal 2010, reductions in demand were acute over the last four quarters, with ALM licensing revenue falling below \$4 million per quarter. The reductions in demand virtually eliminated large license transactions from new customers and negatively affected smaller add-on transactions from existing customers. Maintenance revenue continued to grow steadily throughout this period as customers largely kept current on maintenance.

Throughout the past year, the Company has won mandates from major new customers in spite of the inability of many to make immediate license purchases. New customers have continued to engage services personnel to configure the Company's product for future implementations. Although the Company has not seen an increase in capital spending so far in the first calendar quarter of 2010, when the majority of its customers typically establish new capital spending budgets for that year, customer sentiment appears to be coming more favourable concerning the availability of capital budget. In response to the improving environment, the Company has begun to make additions to its field force to respond to these and other signs of increasing demand.

ALM license revenue increased by 37% to \$3.8 million in the three months ended January 31, 2010 compared to \$2.8 million in the three months ended January 31, 2009. Sequentially, on a year to date basis, ALM license revenue is 8% lower than the same period in the prior fiscal year, due to the lower licensing activity in the second quarter of fiscal 2010.

ALM maintenance revenue increased 11% from \$6.3 million in the third quarter of fiscal 2009 to \$7.0 million in the third quarter of fiscal 2010 and increased by 9% on a year to date basis. The increased maintenance revenue was due to the continuation of the Company's consistently high renewal rate of maintenance contracts and to maintenance revenue from incremental licensing transactions. In addition, the Company's maintenance revenue benefited from the relative higher value of the Pound Sterling and Euro against the US dollar over the third quarter of fiscal 2010 compared to the same period in fiscal 2009.

ALM service revenue in the third quarter of fiscal 2010 was \$2.6 million, an increase of \$0.1 million or 3% when compared with the third quarter of fiscal 2009. On a year to date basis, ALM service revenue increased 10% in the nine months ended January 31, 2010 compared with the nine months ended January 31, 2009. The Company continued to work with its major customers on long-term service engagements, assisting them in their increasingly complex planning and rollout initiatives.

The Company experienced an increase in profits in its Interoperability business segment relative to the segment's revenues over the past quarter. Operating income in the Interoperability segment increased from \$0.3 million in the third quarter of fiscal 2009 to \$0.6 million in the third quarter of fiscal 2010, due to higher license revenue compared with the third quarter of fiscal 2009. On a year to date basis, operating income in the Interoperability segment declined from \$1.3 million to \$1.0 million for the nine months ended January 31, 2010 compared with the nine months ended January 31, 2009 due to lower revenue in the first quarter of fiscal 2010. In the Interoperability segment, the Company utilizes both direct and indirect channels of distribution to reach a diverse customer base ranging from large multinational companies to individual developers. The Company continues to conduct research and development in the IO segment to provide its large customer base with up to date features and functionality. However, markets for the Company's Interoperability products are mature and well developed and the Company believes that opportunities to develop new customers for this product line are limited. The Company expects to experience a continuing decline in license and maintenance revenue in this segment as the technology and market for these products continues to mature.

## Supplementary Financial Information

### Selected Unaudited Consolidated Quarterly Financial Information

(in thousands of dollars, except per share amounts)

The following table presents selected unaudited consolidated quarterly financial information for each of the eight quarters ended January 31, 2010. The Company's quarterly operating results have historically fluctuated significantly and may continue to fluctuate significantly in the future due to a variety of factors. Therefore, the Company believes that past operating results and period-to-period comparisons should not be relied upon as an indication of the Company's future performance. See "Risk Factors" below.

	Three Months Ended							
	Apr 30	Jul 31	Oct 31	Jan 31	Apr 30	Jul 31	Oct 31	Jan 31
	2008	2008	2008	2009	2009	2009	2009	2010
License revenue	\$ 12,128	\$ 6,156	\$ 6,425	\$ 3,702	\$ 3,989	\$ 5,624	\$ 3,921	\$ 4,963
Maintenance revenue	6,646	7,035	7,051	6,980	6,897	7,415	7,797	7,750
Service revenue	2,386	2,174	2,792	2,521	2,696	2,701	2,959	2,599
<b>Total revenue</b>	<b>\$ 21,160</b>	<b>\$ 15,365</b>	<b>\$ 16,268</b>	<b>\$ 13,203</b>	<b>\$ 13,582</b>	<b>\$ 15,740</b>	<b>\$ 14,677</b>	<b>\$ 15,312</b>
Income from operations	\$ 4,123	\$ 1,149	\$ 1,958	\$ 418	\$ 627	\$ 2,319	\$ 2,213	\$ 1,714
Net income	\$ 4,717	\$ 619	\$ 1,353	\$ 325	\$ 1,989	\$ 1,407	\$ 1,611	\$ 1,106
- per share, basic	\$ 0.46	\$ 0.06	\$ 0.13	\$ 0.03	\$ 0.20	\$ 0.14	\$ 0.16	\$ 0.11
- per share, diluted	\$ 0.46	\$ 0.06	\$ 0.13	\$ 0.03	\$ 0.20	\$ 0.14	\$ 0.16	\$ 0.11
Total assets	\$ 42,264	\$ 36,888	\$ 33,851	\$ 36,284	\$ 37,103	\$ 40,159	\$ 38,021	\$ 40,385
Cash dividends per share	\$ 0.100	\$ 0.100	\$ 0.100	\$ 0.100	\$ 0.100	\$ 0.125	\$ 0.125	\$ 0.150

Key factors that account for the fluctuations in quarterly results for the periods indicated include the variability in the Company's licensing revenue, changes in the cost of the Company's sales force, the economic downturn that commenced in the second quarter of fiscal 2009 and the impact of currency movements against the US dollar. As the timing of larger license transactions changes from quarter to quarter, the impact on license revenue is significant. In the three months ended April 30, 2008 and July 31, 2009, the Company completed \$5 million and \$2 million licensing transactions, respectively, in its ALM segment.

The current economic environment is a significant factor affecting the variability of the Company's license revenue on a quarterly basis. Lower license revenue in the last consecutive four quarters, with the exception of the one significant license transaction in the first quarter of fiscal 2010, was a reflection of procurement delays with the Company's larger customers due to spending freezes as well as due to lower initial orders than would otherwise have been received in a stronger economy. The Company did not make any significant reductions in its workforce or changes to its structure attributable to economic weakness in prior quarters. The Company's annual sales conference, which is typically a first quarter expense of approximately \$0.5 million, was cancelled for fiscal 2010, resulting in a cost reduction in the first nine months of fiscal 2010 compared with the same period of fiscal 2009.

The movement of the Canadian dollar against the US dollar has a direct impact on the Company's financial results. The Company's main development and administrative costs are based in Canadian dollars. As a result, all other things being equal, as the Canadian dollar strengthens against the US dollar, the Company's cost base is increased. The Company has entered into a hedging program to help stabilize the costs and mitigate the risks of significant short-term Canadian dollar volatility to the US dollar.

As at January 31, 2010, 10,122,000 common shares of the Company and options to purchase 1,335,000 common shares of the Company were outstanding.

## Financial Results Analysis

This section discusses the consolidated financial results of the Company and each of its operating segments for the third quarter of fiscal 2010 and fiscal 2009. Revenue and operating income from operations are analyzed on a segmented basis.

### Revenue

(in thousands of dollars, except percentages)

	For the three months ended			For the nine months ended		
	Jan 31 2010	Jan 31 2009	% Change	Jan 31 2010	Jan 31 2009	% Change
<b>ALM segment:</b>						
License revenue	\$ 3,791	\$ 2,768	37%	\$ 11,811	\$ 12,794	-8%
Maintenance revenue	6,957	6,277	11%	20,639	18,933	9%
Service revenue	2,599	2,521	3%	8,259	7,487	10%
	13,347	11,566	15%	40,709	39,214	4%
<b>Interoperability segment:</b>						
License revenue	1,172	934	25%	2,697	3,489	-23%
Maintenance revenue	793	703	13%	2,323	2,133	9%
	1,965	1,637	20%	5,020	5,622	-11%
<b>Total revenue</b>	<b>\$ 15,312</b>	<b>\$ 13,203</b>	<b>16%</b>	<b>\$ 45,729</b>	<b>\$ 44,836</b>	<b>2%</b>

### ALM Segment

License revenue is primarily generated through the sale of perpetual licenses of the Company's main ALM product, MKS Integrity, to both new and existing customers. The increased acceptance of MKS Integrity as an enterprise ALM platform is enabling the Company to compete for larger and more numerous installations than in the past. The increased breadth of the Company's product offering, which affects multiple departments and various functional areas within its customers' engineering and IT departments, has increased the value and size of implementations in the Company's customer base. The demand for MKS Integrity with companies who embed software within their products appears to be increasing as the complexity of software in their products is rapidly evolving and is becoming more and more unmanageable by traditional means.

License revenue increased 37% in the third quarter of fiscal 2010 compared with the third quarter of fiscal 2009 as the Company completed larger licensing transactions than in the prior comparative quarter. License revenue declined 8% for the nine months ended January 31, 2010 compared with the nine months ended January 31, 2009 due to the weaker general economic conditions in the first half of fiscal 2010 compared with the first half of fiscal 2009.

Maintenance revenue consists of maintenance contracts sold with new products for a period that is generally twelve months, as well as renewal maintenance contracts to existing customers for the second and subsequent maintenance periods.

Maintenance revenue grew 11% in the three months ended January 31, 2010 compared with the three months ended January 31, 2009 and grew 9% in the nine months ended January 31, 2010 compared with the nine months ended January 31, 2009. The increases were primarily attributable to the incremental maintenance component of new transactions and the extension of maintenance contracts by existing customers for additional maintenance periods in order to gain access to product upgrades and MKS support services. During the third quarter of fiscal 2010, the Company continued to maintain its high maintenance contract renewal rate, with over 90% of the total value of expiring annual enterprise ALM customer maintenance contracts being renewed. The Company experiences a higher renewal rate on installations of its products with its large accounts compared to smaller accounts. In addition, with approximately 35% of the Company's maintenance base being denominated in non-US currencies (primarily the Pound Sterling and Euro), the Company benefited from a relative higher value of those currencies against the US Dollar during the third quarter of fiscal 2010.

Service revenue is generated by providing process consulting, installation services, user training, conversion services and other product feature/configuration consulting to ensure successful deployment of the Company's products to meet its customers' needs. Services are delivered on a regional basis by the Company's employees and services partners, and are generally priced based on a daily rate. Service revenue for the three months ended January 31, 2010 increased 3% over the same period in fiscal 2009 and for the nine months ended January 31, 2010 increased 10% over the same period in fiscal 2009. The increase in service revenue in the fiscal 2010 compared with fiscal 2009, on a third quarter and year to date basis, was driven by a strong backlog of services sold in licensing transactions recorded in previous quarters. As the Company's customers continue to undertake larger implementations, the complexity of the projects has increased as well as their scope, intensity and duration. These longer, more complex services arrangements with the Company's key customers have assisted in the planning and deployment of previously licensed software, which the Company believes will accelerate the timeline for future follow on purchases from these customers. The Company continues to grow its service revenue through key engagements with customers in all of its geographic segments and increase its penetration into key accounts.

### Interoperability Segment

The MKS Interoperability segment's product, MKS Toolkit, addresses the issues surrounding UNIX-Windows operating system co-existence, cross-platform development, application migration, systems administration and network management. The markets for the Company's Interoperability products are mature and well developed and the Company believes that opportunities to develop new customers for this product line are limited. The Interoperability segment has been in long-term decline due to (i) a continuing shift by the market to port UNIX applications to the Linux operating system instead of Windows NT, thus not utilizing the Company's MKS Toolkit products to port from UNIX to Windows NT, and (ii) increased levels of competition in this segment from both freeware and other low-cost alternatives which remain prevalent in the UNIX to Windows interoperability market. While this segment is not viewed as strategic to the Company, the segment has consistently generated profits and cash flow to fund the ALM segment of MKS's business. The Interoperability segment experienced a 20% increase in revenue in the third quarter of fiscal 2010 compared to the third quarter of fiscal 2009 and an 11% decline in revenue for the nine months ended January 31, 2010 compared with the same period in fiscal 2009.

License revenue increased from \$0.9 million for the three months ended January 31, 2009 to \$1.2 million for the three months ended January 31, 2010. On a year to date basis, license revenue decreased from \$3.5 million for the nine months ended January 31, 2009 to \$2.7 million for the nine months ended January 31, 2010. The general maturity of the segment, general economic weakness and competitive market conditions have generally resulted in declining licensing fees, however in the three months ended January 31, 2010, several larger deals were completed, resulting in the increased revenue for the current period. Over the long-term, and consistent with the maturing of the technology and the market, the Company expects a continuing decline in license revenue from its Interoperability segment at the rate of approximately 10% annually.

Maintenance revenue increased to \$0.8 million in the three months ended January 31, 2010 compared \$0.7 million in the three months ended January 31, 2009. On a year to date basis, maintenance revenue increased from \$2.1 million at January 31, 2009 to \$2.3 million at January 31, 2010. The increase in the quarter and on the year to date basis was related to a few larger maintenance renewal contracts completed during the three months ended January 31, 2010. Over time, customers re-write their software code and, during that process, eliminate the reliance on the Interoperability segment's products to port the application from one operating system to another. In line with the Company's expectations, a decline in the maintenance base is expected to continue to occur in future periods.

**Operating Income**  
(in thousands of dollars)

	For the three months ended			For the nine months ended		
	Jan 31 2010	Jan 31 2009	% Change	Jan 31 2010	Jan 31 2009	% Change
Revenue:						
ALM segment	\$ 13,347	\$ 11,566	15%	\$ 40,709	\$ 39,214	4%
Interoperability segment	1,965	1,637	20%	5,020	5,622	-11%
	15,312	13,203	16%	45,729	44,836	2%
Operating expenses:						
ALM segment	12,212	11,456	7%	35,512	37,035	-4%
Interoperability segment	1,386	1,329	4%	3,971	4,276	-7%
	13,598	12,785	6%	39,483	41,311	-4%
Operating income:						
ALM segment	1,135	110	932%	5,197	2,179	139%
Interoperability segment	579	308	88%	1,049	1,346	-22%
	\$ 1,714	\$ 418	310%	\$ 6,246	\$ 3,525	77%

The consolidated income from operations was \$1.7 million for the third quarter of fiscal 2010 compared with \$0.4 million for the third quarter of fiscal 2009, as the Company benefited from higher revenue while maintaining the operating expense levels in both the quarter and year to date periods. Operating expenses were \$13.6 million and \$12.8 million, respectively, in the same periods, a 6% increase. The impact of currency movements against the US dollar during the three months ended January 31, 2010 versus the three months ended January 31, 2009 accounted for a reduction in costs of approximately \$0.7 million.

During the third quarter of fiscal 2010, the Company benefited from a lower Canadian dollar exchange rate with respect to the US dollar because of the Company's hedging program. The exchange rate decreased to \$0.84 during the three months ended January 31, 2010 versus \$0.93 for the three months ended January 31, 2009, which decreased costs in the quarter by approximately \$0.6 million. This cost decrease affected the departmental areas containing a significant number of the Company's Canadian employees, namely research and development and general and administrative. In addition, the Company recorded a negligible foreign exchange loss on balance sheet items in the three months ended January 31, 2010 compared to a foreign exchange gain of \$0.2 million recorded in the three months ended January 31, 2009.

For the nine-month period ended January 31, 2010, consolidated income from operations was \$6.2 million compared with \$3.5 million for the same period in fiscal 2009, with operating expenses decreasing from \$41.3 million to \$39.5 million over the same periods. In addition to the benefit of the foreign exchange and currency movements discussed above, which totaled \$1.3 million on a year to date basis, travel costs related to the cancellation of the Company's calendar 2009 sales conference amounted to an additional cost savings of \$0.5 million.

The following table sets forth, for the periods indicated (in thousands of dollars, except exchange rate information): (i) the Company's operating costs incurred in Canadian dollars and as a percentage of its total operating costs, (ii) the average exchange rate for one Canadian dollar expressed in US dollars based upon the noon buying rates provided by the Bank of Canada, and (iii) the effective exchange rate between US dollars and Canadian dollars, after giving effect to hedging activities undertaken by the Company.

	FY09 Q1	FY09 Q2	FY09 Q3	FY09 Q4	FY10 Q1	FY10 Q2	FY10 Q3
Quarterly Canadian dollar costs	\$ 5,644	\$ 5,189	\$ 5,180	\$ 5,245	\$ 5,329	\$ 5,016	\$ 5,635
Percentage of total costs	39%	33%	33%	37%	37%	34%	35%
Average exchange rate	\$ 0.99	\$ 0.92	\$ 0.82	\$ 0.80	\$ 0.88	\$ 0.93	\$ 0.95
Effective exchange rate after hedging activities	\$ 0.99	\$ 0.96	\$ 0.93	\$ 0.91	\$ 0.92	\$ 0.85	\$ 0.84

In order to mitigate the fluctuations between the value of Canadian and US dollars, the Company initiated in the third quarter of fiscal 2009 a hedging program relating to its Canadian dollar costs. The program resulted in Canadian dollar operating costs being recorded at an average rate of \$0.84 for the third quarter of fiscal 2010. The Company has also entered into hedging transactions to buy Canadian dollars on a schedule consistent with the Company's expected requirements.

The following table sets forth, for the periods indicated (in thousands of dollars, except exchange rate information), information concerning the total amount of Canadian dollars subject to hedging transactions entered into by the Company as of the date of this MD&A and the average exchange rate for one Canadian dollar expressed in US dollars.

	FY10 Q4	FY11 Q1	FY11 Q2	FY11 Q3	FY11 Q4	FY12 Q1	FY12 Q2	FY12 Q3	FY12 Q4
Quarterly Canadian dollars hedged	\$ 3,800	\$ 3,787	\$ 3,787	\$ 3,787	\$ 3,787	\$ 3,795	\$ 3,795	\$ 3,630	\$ 3,795
Average hedged rate for the period	\$ 0.80	\$ 0.80	\$ 0.92	\$ 0.92	\$ 0.92	\$ 0.95	\$ 0.95	\$ 0.95	\$ 0.93

### Cost of Product and Support

Cost of product and support consists of costs incurred to deliver the Company's product to customers, including royalty costs paid to third parties for technology embedded in the product, and to provide telephone support for customers under maintenance contracts. On a Company-wide basis, cost of product and support increased 15% in the third quarter of fiscal 2010 compared to the third quarter of fiscal 2009 and increased 3% for the nine months ended January 31, 2010 compared with the nine months ended January 31, 2009. The cost increase was primarily related to increased support personnel costs, as new staff was added to support the growing maintenance base of the Company. Average support headcount for the quarter ended January 31, 2010 increased to 53 from 46 in the quarter ended January 31, 2009.

### Cost of Service

Cost of service increased 15% from \$1.6 million in the third quarter of fiscal 2009 to \$1.9 million in the third quarter of fiscal 2010 and remained constant in the nine months ended January 31, 2010 compared with the nine months ended January 31, 2009. Services margins decreased to 28% in the third quarter of fiscal 2010 compared with 35% in the third quarter of fiscal 2009 due to a decrease in utilization as the Company invested in its technical field force to meet the anticipated future demand. On a year to date basis, service margins increased to 35% for the nine months ended January 31, 2010 compared with a service margin of 28% for the nine months ended January 31, 2009. The Company continues to benefit from the strong margins and high utilizations obtained in the first half of the fiscal year that have maintained the strong year to date margins. Average service headcount increased to 39 in the third quarter of fiscal 2010 compared to 35 in the third quarter of fiscal 2009.

### Sales and Marketing

Sales and marketing costs increased \$0.2 million, or 4%, in the three months ended January 31, 2010 compared with the three months ended January 31, 2009 and declined by 7% in the nine months ended January 31, 2010 compared with the nine months ended January 31, 2009. The year to date decline in sales and marketing costs were achieved through reduced spending on marketing activities. The Company plans to continue to make additional investments in the sales force in response to anticipated increases in demand in key customer sectors.

### Research and Development

Research and development expenses declined \$0.2 million or 5% in the third quarter of fiscal 2009 compared to the third quarter of fiscal 2010 and declined 4% in the nine months ended January 31, 2010 compared with the nine months ended January 31, 2009. Since the majority of the Company's research and development takes place in Canada, the effect of the declining Canadian dollar accounted for \$0.2 million of the decrease in costs in the quarter and \$0.5 million year to date. Headcount increased by five from the third quarter of fiscal 2009 to the third quarter of fiscal 2010. As the Company continues to expand its customer base, continued spending in the ALM segment on research and development is essential to maintain and further expand on its products. Research and development costs for the IO segment remained constant from the third quarter of fiscal 2009 to the third quarter of fiscal 2010.

### General and Administrative

General and administrative expenses increased 6% to \$2.1 million in the three months ended January 31, 2010 compared with \$2.0 million in the three months ended January 31, 2009. On a nine-month basis, general and administrative expenses were \$6.1 million in the period ended January 31, 2010 compared with \$5.9 million in the period ended January 31, 2009. As a percentage of total revenue, general and administrative costs were 14% in the third quarter of fiscal 2010, compared with 15% in the first quarter of fiscal 2009.

### Foreign exchange

Due to changes in currency exchange rates during the three months ended January 31, 2010, a negligible foreign exchange loss was incurred in the third quarter of fiscal 2010 compared to a \$0.2 million foreign exchange gain in the third quarter of fiscal 2009. The foreign exchange gains and losses related to the conversion of balance sheet items to the period end exchange rates.

### Interest Income

During the three and nine months ended January 31, 2010 interest was generated from short-term investment grade interest-bearing securities. Low short-term interest rates resulted in lower overall interest income.

### Income Taxes

In the third quarter of fiscal 2010, the Company recorded non-cash, deferred income tax expense for accounting purposes of \$0.5 million. This expense resulted from the utilization of the Company's deferred tax asset, the benefit of which was recognized in prior quarters. A \$0.1 million current income tax expense was also recorded.

Realization of the net deferred tax asset is dependent on generating sufficient future taxable income on a jurisdiction-by-jurisdiction basis. Although realization is not assured, the Company believes it is more likely than not that a portion of the deferred tax asset will be realized and, as a result, the appropriate recovery has been recorded. As factors change in the future, this estimate could change in the near term as estimated future taxable income in each legal entity changes.

## Liquidity and Capital Resources

### Operating Activities

The Company generated \$4.8 million of cash from operating activities in the third quarter of fiscal 2010 compared with cash provided by operating activities of \$6.2 million in the third quarter of fiscal 2009. Days sales outstanding in accounts receivable at January 31, 2010 were 47 days compared to 50 days at April 30, 2009. The decrease in days sales outstanding was primarily attributable to strong collections. Deferred revenue increased by \$0.5 million at January 31, 2010 compared to April 30, 2009 due to the timing of maintenance renewals and the growing end user base of the Company. As the Company expects to renew the majority

of its maintenance contracts in the ALM segment in the last two quarters of each fiscal year, the Company believes that the usual trend of higher cash balances in the third and fourth quarters will continue.

### Investing Activities

Purchases of fixed assets amounted to \$0.3 million in the third quarter of fiscal 2010 compared with \$0.2 million in the third quarter of fiscal 2009. Capital spending relates to leasehold improvements and computer hardware and software acquisitions in order to replace aging equipment, to provide enhanced security and productivity and to support growth in operations.

### Financing Activities

The Company maintains a policy to pay quarterly dividends, and declared and paid quarterly dividends on its common shares of \$0.15 per share on January 15, 2010 compared with a dividend of \$0.10 per share on January 15, 2009. The Company's intention is to pay a quarterly dividend so long as the payment of the dividend does not impair the Company's financial position.

The Company received \$0.2 million during the third quarter of fiscal 2010 from the issuance of common shares upon the exercise of stock options under the Company's employee stock option plans and the employee share purchase plan.

### Capital Resources

The Company's primary sources of liquidity are its cash generated by operations and working capital. The Company had cash and cash equivalents totaling \$22.1 million as at January 31, 2010, compared with \$17.1 million at April 30, 2009.

The Company continues to perform relatively well in the current economic climate. The Company's revenues were higher in the three and nine months ended January 31, 2010 when compared to the same periods in fiscal 2009 and the Company also had higher profitability compared to the same three and nine month periods in the prior year. Maintenance contracts continue to provide positive cash flow, and have not been significantly affected by the current global economic climate to date. The Company has started to increase its investment in its field force to provide capacity as it anticipates that the economic environment will improve. The Company's cash balance grew during the first nine months of fiscal 2010, consistent with its normal seasonal cycle, and the Company believes that it is well positioned to finance its working capital and capital expenditure requirements for the next twelve months. If the Company's spending plans change, the Company may find it necessary to seek additional sources of equity or debt financing and/or reduce or eliminate its quarterly dividend to support its capital needs. If the Company does need to seek additional financing, there is no assurance that this additional financing will be available in amounts or on terms favourable to the Company, or at all, and not dilutive to the Company's shareholders.

The key factors that could negatively impact the liquidity of the Company include: the profitability of the Company; fluctuation in exchange rates, particularly the weakening of the US dollar compared with the Canadian dollar as the Company's financial results are reported in US dollars while the Company incurs approximately one-third of its expenses in Canadian dollars; fluctuations in the price of the Company's common shares below the current market price of those shares thereby reducing the likelihood that outstanding stock options will be exercised; the long sales cycles associated with selling to Global 1000 companies, which could lead to fluctuating quarterly results; declining levels of renewal of annual maintenance contracts with the installed base of customers in the Company's ALM segment; and the extent and duration of the current economic downturn in the North American economy, where the Company derives approximately sixty to seventy percent of its revenue, as that downturn impacts general levels of capital procurement by large corporations. See "Risk Factors".

The Company may make strategic investments in related products or businesses. The Company may utilize a portion of its cash balances or issue additional share capital or debt to finance such investments.

### Contractual Obligations

The following table provides a summary of the Company's contractual obligations for the periods indicated.

	Fiscal year ended April 30						
(thousands of dollars)	2010	2011	2012	2013	2014	Thereafter	Total
Operating lease obligations <sup>1</sup>	\$ 554	\$ 1,363	\$ 620	\$ 455	\$ 320	\$ 379	\$ 3,691
Purchase obligations <sup>2</sup>	293	70	-	-	-	-	363
	\$ 847	\$ 1,433	\$ 620	\$ 455	\$ 320	\$ 379	\$ 4,054

<sup>1</sup>The Company is also responsible for certain common area costs at its various leased premises.

<sup>2</sup>Represents commitments under certain contractual arrangements to make future payments for goods and services to be used in the normal course of business.

### Outlook for Fiscal 2010

MKS is committed to profitable organic growth in its primary operating segment, ALM. The Company strives to maintain a balance between increasing current shareholder returns and funding research and field force investments for long-term growth. The Company is making investments in its field force to meet anticipated increases in demand as the mandates received from major customers mature and the availability of capital to fund those mandates improves.

The Company expects a long term decline in the Interoperability business of approximately 10 percent annually.

Income tax expense is recorded in the Company's financial statements going forward at the prevailing tax rate in the jurisdiction where the income was generated to the extent a deferred tax asset has been recorded in that jurisdiction. Such rate may be higher than the average rate the Company expects to pay in the future across all jurisdictions. This will be subject to an ongoing quarterly assessment of the valuation allowance by jurisdiction, which may give rise to further increases or decreases to the existing tax asset.

## Off-Balance Sheet Arrangements

The Company does not have any off-balance sheet arrangements such as special purpose or variable interest entities.

## Impact of New Accounting Pronouncements

Please see note 1 to the consolidated financial statements of the Company for the fiscal year ended April 30, 2009 for more information about the accounting policies of the Company.

## Related Party Transactions

During the three months ended January 31, 2010, the Company did not engage in any transactions involving related parties.

## Controls and Procedures

In compliance with the Canadian Securities Administrators' National Instrument 52-109 ("NI 52-109"), the Company has filed with applicable Canadian securities regulatory authorities, certificates signed by its Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") that, among other things, report on the design and effectiveness of disclosure controls and procedures and the design of internal controls over financial reporting.

### Disclosure controls and procedures

The CEO and CFO have designed disclosure controls and procedures, or have caused them to be designed under their supervision, to provide reasonable assurance that material information relating to the Company has been made known to them and has been properly disclosed in the Company's regulatory filings. As of January 31, 2010, an evaluation was carried out, under the supervision of the CEO and CFO, of the effectiveness of the Company's disclosure controls and procedures as defined in NI 52-109. Based on this evaluation, the CEO and the CFO concluded that the design and operation of these disclosure controls and procedures were effective. This evaluation took into consideration the Company's disclosure policy, a sub-certification process and the functioning of its Disclosure Committee.

### Changes in internal controls over financial reporting

There were no changes in the Company's internal controls over financial reporting that occurred during the third quarter of fiscal year 2010 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

## Adoption of International Financial Reporting Standards

In January 2006, the Accounting Standards Board (the "AcSB") announced its decision to require all publicly accountable enterprises to report under International Financial Reporting Standards ("IFRS") for years beginning on or after January 1, 2011. On February 13, 2008, the AcSB confirmed that publicly accountable enterprises will be required to use IFRS, as issued by the International Accounting Standards Board, unless modifications or additions to the requirements of IFRS are issued by the AcSB. IFRS must be adopted for interim and annual financial statements related to fiscal years beginning on or after January 1, 2011, with restatement of comparative periods.

During fiscal 2010, the Company commenced a comprehensive IFRS conversion plan which addressed changes in accounting policies, restatement of comparative periods, organization, internal controls and any required changes to business processes for the Company's Canadian GAAP financial statements.

There will be no impact to the Company's US GAAP financial statements upon conversion from Canadian GAAP to IFRS. Please see the Canadian GAAP MD&A dated February 22, 2010 for more detailed information on the adoption of IFRS.

## Critical Accounting Policies and Estimates

The consolidated financial statements of the Company for the three and nine months ended January 31, 2010 have been prepared in accordance with US GAAP. Refer to note 1 in the consolidated financial statements of the Company for the fiscal year ended April 30, 2009 for more information about the accounting policies applied in the preparation of the financial statements. The preparation of the financial statements in accordance with US GAAP requires management to make certain estimates, judgments and assumptions. Management continually evaluates these estimates, judgments and assumptions based on past experience and other relevant factors and believe them to be reasonable based upon information available to management at the time. Because this involves varying degrees of judgment and uncertainty, the amounts currently reported in the financial statements could, in the future, prove to be inaccurate. The accounting policies that reflect management's estimates that are more significant, judgments and assumptions and which management believes are the most critical to aid in fully understanding and evaluating the reported financial results include the following:

### Revenue Recognition

The Company follows the provisions of Statement of Position (SOP) 97-2, "Software Revenue Recognition" and Staff Accounting Bulletin (SAB) 104, "Revenue Recognition in Financial Statements". Revenue is recognized from the sale of product and software licenses when delivery has occurred based on purchase orders, contracts or other documentary evidence, provided that collection of the resulting receivable is deemed probable by management. A provision is made for estimated sales returns and other insignificant vendor obligations. Revenue from post-contract customer support is recognized ratably over the period that the customer support services are provided, which is generally one year. The amount of revenue allocated to this undelivered service is

based on the vendor-specific objective evidence, is recorded as unearned, and the difference between the total contract fee and the amount recorded as unearned for the undelivered service is recognized as revenue related to delivered elements of the contract. Revenue from consulting, training and other services are recognized as services are performed. Deferred revenue represents unearned income associated with support agreements, software license revenue where significant vendor obligations remain and any other situations where payments are received in advance of revenue recognition.

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

The Company maintains allowances for losses that could result from customers who do not make the required payments. The allowance is estimated based on the likelihood of recovering the accounts receivable. This is based on experience, taking into account current and expected collection trends.

If economic conditions worsen and customer losses increase, the allowance for doubtful accounts will increase by recording an additional expense to the statement of operations.

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

Impairment of long-lived assets is assessed when events or changes in circumstances indicate that the carrying value of the asset may not be recovered.

In the case of goodwill, the Company no longer amortizes these assets as a result of an accounting change in fiscal 2002. However, goodwill impairment is assessed annually and when events or changes in circumstances indicate that goodwill might be impaired. This involves forecasting cash flows and market multiples used to value the assets. There is uncertainty in these estimates as the related cash flows are projected for future years based on underlying assumptions such as volume growth, inflation factors and industry trends that may or may not materialize. Management uses its best efforts to forecast these amounts, but the actual amounts may vary from the estimated numbers. The impairment test is based on a projected discounted cash flow method. The Company believes that the estimate of future cash flows and fair value are reasonable. The assumptions used are consistent with internal budgets and reflect best estimates, but they have inherent uncertainties that management may not be able to control. As a result, the amounts reported for these items could be different if different assumptions were used, or if conditions change in the future.

#### **Income Taxes**

The Company believes that it has adequately provided for income taxes based on all of the information that is currently available. Tax filings are subject to audits, which could materially change the amount of current and deferred income tax assets and liabilities. As outlined in note 4 in the audited annual financial statements of the Company for the year ended April 30, 2009, a valuation reserve has been taken against a portion of the deferred tax assets of the Company, affecting the deferred tax assets recorded in the Company's financial statements.

The Company assesses the realization of these deferred tax assets quarterly by jurisdiction to determine whether an income tax valuation allowance is required. Based on available evidence, both positive and negative, it is determined whether it is more likely than not that all or a portion of the deferred tax assets will be realized on a jurisdiction-by-jurisdiction basis. The main factors that provide evidence about the ability to realize the net deferred tax asset include the following:

- the amount of, and trends related to, cumulative earnings or losses realized over the most recent 12 quarters;
- the current period net earnings (loss);
- future earnings projections as determined through the use of internal forecasts, including the impact of sales pipeline and existing and future maintenance contracts;
- the ability of the Company to carry forward tax losses and investment tax credits, including tax planning strategies to accelerate utilization of such assets;
- industry, business, or other circumstances that may adversely affect future operations; and
- the nature of the future income required to realize the Company's deferred tax assets.

In evaluating the positive and negative evidence, the weight that is assigned to each type of evidence is proportionate to the extent to which it can be objectively verified.

Any future change to the valuation allowance of the deferred tax asset would result in an income tax expense or recovery on the income statement in that future period. Realization of the net deferred tax assets is dependent on generating sufficient taxable income in certain legal entities. Although realization is not assured, the Company believes it is more likely than not that the net amount of the deferred tax asset will be realized. However, this estimate could change in the near term as estimated future taxable income in these certain legal entities changes. If the Company achieves a consistent and substantial level of profitability, the likelihood of the Company recording a future tax asset for some portion of the losses incurred in prior periods in one of its business jurisdictions will increase.

#### **Stock Option Accounting**

In accordance with SFAS 123(R), the Company estimates the fair value of its options for financial accounting purposes using the Black-Scholes model, which requires a number of subjective assumptions, including the expected life of the option, risk-free interest rate, dividend rate, forfeiture rate, future volatility of the price of our common shares and vesting period. The use of subjective assumptions could materially affect the fair value estimate. The Company estimates the volatility of the share price based on the historical trading information of the Company. The Company estimates the risk-free interest rate based on US Treasury rates with a yield equal to the expected life of the option. The Company bases the estimate of the expected life of the option based on historical Company data and the period for which the Company's options can be exercised. The Company assesses our forfeiture rate through an analysis of the turnover of the Company's employees since it commenced issuing options. The fair values of the options issued are being recognized as compensation expense over the applicable vesting period of four years on a straight-line basis.

## Risk Factors

An investment in the securities of the Company involves risks. In addition to the other information contained in this MD&A, investors should carefully consider the risks described below before investing in the Company's securities. The risks described below are not the only ones facing the Company. Additional risks not currently known to the Company or that the Company currently believes are immaterial may also impair the business, results of operations, financial condition and liquidity of the Company.

### Development of the ALM Market

The Company's strategy is to focus its sales and marketing efforts on the enterprise segment of the ALM market, a segment that the Company believes is comprised of large corporations that have a need to improve the productivity, processes and governance over internally developed software in large, dispersed IT departments. This segment of the market is currently estimated to be 10% of the total ALM market of approximately \$1 billion annually. The Company believes that the enterprise segment of the ALM market will grow faster than the traditional desktop segment that has been in decline in recent years due to high levels of competition.

As part of its strategy, over the past few quarters, MKS has released technology upgrades that extend the applicability of its platform across a significantly broader user base within its target enterprise customers. While this has generated significant interest among new large enterprise customers, increasing the value of the Company's solution and promising to establish much deeper adoption of the platform by them, it has added to the complexity of sales initiatives and lengthened sales cycles.

The Company has focused its ALM strategy on penetrating Global 1000 companies. This strategy has had, and may continue to have, an effect on the size and timing of license transactions and has increased and may continue to increase the Company's operating expenses (which may adversely affect the Company's operating income and net income if revenues do not increase proportionately) and the variability of the length of the sales cycle for the Company's enterprise ALM products.

There is no assurance that the Company's strategy will be successful or that the Company will develop a profitable business from selling its products and services into this segment of the market. The Company's future financial performance will depend in large part on the continued growth in the number of businesses adopting ALM products and the expansion of the products' use on a company-wide basis.

### Economic Uncertainty

Many of the Company's customers continue to be affected by economic conditions currently affecting the broader market, which remains a key factor affecting the variability of the Company's license revenue on a quarterly basis. The current economic climate has led to procurement delays with the Company's larger customers due to spending freezes and lower initial orders than would have been received in a stronger economy. Current and future conditions in the domestic and global economies remain uncertain. As a result, it is difficult to estimate the level of growth or contraction for the economy as a whole. It is even more difficult to estimate growth or contraction in various parts, sectors and regions of the economy, including the markets in which the Company participates. Because all components of the Company's budgeting and forecasting are dependent upon estimates of growth or contraction in the markets it serves and demand for its products and services, the prevailing economic uncertainties render estimates of future income and expenditures very difficult to make. Adverse changes may occur as a result of soft economic conditions, wavering consumer confidence, unemployment, declines in stock markets, contraction of credit availability, declines in real estate values, or other factors affecting economic conditions generally. These changes may negatively affect the sales of the Company's products and services, increase exposure to losses from bad debts, or increase the cost and decrease the availability of financing.

### Currency Exchange Rate Fluctuations

The Company's financial results are reported in US dollars. Recent changes in the exchange rate between the United States dollar and the Canadian dollar, Pound Sterling and the Euro have had the effect of decreasing revenues and operating income earned and decreasing reported expenses incurred in Europe, while increasing reported expenses incurred in Canada, as a significant portion of the Company's expenses are incurred in non-US currencies. Future fluctuations in those exchange rates could continue to have an effect on the Company's business and results of operations. In particular, a decline in the value of the United States dollar relative to the Canadian dollar could have a material adverse effect on the Company's results of operations and cash flows. The Company enters into foreign currency cash flow hedges to partially mitigate this risk.

A portion of the Company's sales outside of Canada and the United States are denominated in local currencies such as Pound Sterling and Euros. Appreciation in the value of the United States dollar in relation to foreign currencies may adversely affect the ability of the Company to compete with respect to sales to foreign customers, or compel the Company to maintain price levels in local currencies, which could reduce the realized price in US dollars, thereby negatively affecting revenue and profitability of foreign operations.

### Fluctuation in Quarterly Results

The Company's quarterly revenues and operating results have fluctuated significantly in the past and are likely to fluctuate substantially from quarter to quarter in the future. Such fluctuations may result in volatility in the price of the Company's common shares ("Common Shares"). Quarterly revenues and operating results may fluctuate as a result of a variety of factors, including general economic conditions, demand for the Company's products, the proportion of revenues attributable to license versus maintenance and service revenues, the timing of larger licensing transactions, the introduction of new products and product enhancements by the Company or its competitors, changes in the Company's pricing policies or those of its competitors, the geographical mix of the Company's sales, currency exchange rate fluctuations, unanticipated product discontinuation or deferrals by the Company's OEM customers, the fixed nature of a significant portion of the Company's operating expenses, particularly personnel, research and development and leases, and competitive conditions in the ALM and Interoperability markets. In the ALM segment of its business, the Company has focused its strategy on penetrating Global 1000 companies. This strategy has had, and may continue to have, an effect on the size and timing of license transactions and has increased and may continue to increase the Company's operating expenses (which may adversely affect the Company's operating income and net income if revenues do not increase proportionately) and the variability of the length of the sales cycle for the Company's enterprise ALM products.

The Company has historically operated with little license revenue backlog because its software products are generally shipped as orders are received. In addition, the Company has often recognized a substantial portion of its revenues in the last month of a quarter and often in the last week or days of that month. As a result, license fees in any quarter are substantially dependent on orders booked and shipped in the last month or last week of that quarter. Accordingly, a small variation in the timing of recognition of revenues for specific transactions can adversely and disproportionately affect the Company's business, results of operations, liquidity and financial condition because the Company establishes its expenditure levels on the basis of its expected future revenues and only a small portion of the Company's expenses varies with its revenues in the short term.

Due to all of the foregoing factors, the Company's revenues and operating results are difficult to predict and may not meet the expectations of market analysts and investors. In such an event, the trading price of the Common Shares would likely be materially adversely affected. Accordingly, the Company believes that period-to-period comparisons of results of operations are not necessarily meaningful and should not be relied upon as indicative of future performance.

#### **Intense Competition**

The markets for the Company's products and services are intensely competitive and rapidly changing and a number of companies offer products and services similar to the Company's products and services and target the same customers as the Company. The Company believes its ability to compete depends upon many factors within and outside its control, including the timely development and introduction of new products and product enhancements, product functionality, performance, price, reliability, customer service and support, sales and marketing efforts, product distribution, and product releases by competitors.

Many of the Company's competitors and potential competitors are substantially larger than the Company and have greater name recognition, larger customer bases and significantly greater financial, technical, marketing, public relations, sales, distribution, and other resources than the Company. As a result, they may be able to respond more quickly to new or emerging technologies and changes in customer requirements, or to devote greater resources to the development, promotion and sale of their products than the Company.

In addition, the Company anticipates that the quality, functionality and breadth of the Company's competitors' product offerings will improve, and there can be no assurance that the Company will be able to compete effectively with such product offerings. The Company expects that additional competition will develop, both from existing businesses in the ALM and Interoperability markets and from new entrants. Moreover, as competition increases, the prices that the Company charges for its products may decline. In addition, the Company could be materially adversely affected if there were a significant movement towards the acceptance of open source solutions or other alternative technologies that compete with the Company's products. If the Company is not able to compete successfully, the Company's business, financial condition, liquidity and operating results could be materially adversely affected. The Company's most significant direct competitors in the ALM market include IBM Corporation, Serena Software Inc., Computer Associates International, Inc. and Borland Software Corporation, and in the Interoperability market include Microsoft Corporation and Red Hat, Inc.

#### **Management of Growth**

The Company has in the past experienced significant growth in its business, including an expansion in the Company's staff and customer base, the establishment of new distribution channels and the expansion of its product lines. Such growth placed, and may continue to place, a significant strain on the Company's management and operations. The Company's ability to manage growth effectively in the future will require it to further develop and improve its operational, financial and other internal systems, and to hire, train and manage employees. If the Company is unable to manage its growth effectively, the Company's business, results of operations, liquidity and financial condition could be materially and adversely affected.

#### **Rapid Technological Change**

The markets for the Company's products are characterized by rapid technological advances, evolving industry standards, changes in end-user requirements and frequent new product introductions and enhancements. The introduction of products embodying new technologies and the emergence of new industry standards could render the Company's existing products, and products currently under development, obsolete and unmarketable. The Company's future success will depend upon its ability to enhance its current products, and to develop and introduce new products that keep pace with technological developments, respond to evolving end-user requirements and achieve market acceptance. The development of such new products or enhanced versions of existing products entail significant technological risks. There can be no assurance that the Company will be successful in marketing its existing products or be successful in developing or marketing new products or product enhancements on a timely basis, or that the Company will not experience significant delays in development in the future, any of which could have a material adverse effect on the Company's business, results of operations and financial condition.

#### **Dependence on and Retention of Management and Key Employees**

The Company's success will depend to a very significant extent on the performance and continued services of its senior management and certain other key employees, the loss of any of whom could have a material adverse effect upon the Company. In addition, the Company may continue to expand its management team in the future.

The Company believes that its future success will also depend in large part upon its ability to attract and retain highly skilled technical, managerial and marketing personnel. Competition for such personnel is intense and the Company has experienced difficulties in recruiting qualified personnel and may continue to experience such difficulties in the future. There can be no assurance that the Company will be successful in attracting and retaining the personnel it requires to continue to maintain and expand its business. The Company does not have key person life insurance for any of its management team.

#### **International Sales**

The Company believes that its future revenue and operating results will depend in part upon its ability to increase sales in international markets outside North America. A portion of the Company's revenue is derived from sales outside of North America, primarily Europe. Recently, the Company has expanded its Asia-Pacific sales force in order to expand its operations in that region. International sales are subject to various risks, including exposure to currency fluctuations, political and economic instability,

increased difficulty of administering business and the need to comply with a wide variety of international and domestic export laws and regulatory requirements. There are a number of risks inherent in the Company's international activities, including unexpected changes in Canadian or other governmental policies concerning the import and export of goods, services and technology and other regulatory requirements, tariffs and other trade barriers, costs and risks of localizing products for foreign languages, longer accounts receivable payment cycles, limits on repatriation of earnings and the burdens of complying with a wide variety of foreign laws. The financial stability of foreign markets could also affect the Company's international sales. There can be no assurance that such factors will not have a material adverse effect on revenues and expenses of the Company related to international sales and, consequently, the Company's business, results of operations, liquidity and financial condition. In addition, international income may be subject to taxation by more than one jurisdiction, which could also materially adversely affect the Company's results of operations.

#### **Importance of Maintenance Contracts**

Under the Company's annual maintenance contracts, customers are provided with telephone support to assist them in solving technical issues that arise from time to time in deploying and using the Company's software products and are supplied upgrades and patches for the Company's products for the duration of the maintenance period. The upgrades and patches provide new features and functionality as well as fixes to technical problems encountered by the customer installed base. The Company has historically experienced a high rate of renewal of customer contracts in its ALM segment and relies on the cash flow generated from these renewals to fund operations and provide liquidity as the maintenance fees are paid at the beginning of the contract period. Deterioration in the renewal rate of maintenance contracts could materially adversely affect the business, results from operations, liquidity and financial condition of the Company.

#### **Dependence on a Limited Number of Products**

Substantially all of the Company's revenues are currently derived from a limited number of products and services offered by the Company in the ALM and Interoperability markets. Accordingly, the Company's future results of operations will depend, in part, on maintaining and increasing market acceptance of these products and services, as well as on the Company's ability to continue to enhance these products and services to meet the evolving needs of its customers. A reduction in demand or increase in competition in the market for ALM or Interoperability solutions, or a decline in sales of such products and related services, could have a material adverse effect on the Company's business, results of operations, liquidity and financial condition.

#### **Acquisitions**

The Company may in the future further expand its operations or product offerings through the acquisition of additional businesses, products or technologies. There can be no assurances that the Company will be able to identify, acquire or profitably manage additional businesses without substantial expenses, delays or other operational or financial problems. Furthermore, acquisitions also entail numerous risks, including: difficulties in assimilating acquired operations, products and personnel; unanticipated costs, events and legal liabilities; diversion of management's attention from other business concerns; adverse effects on existing business relationships with suppliers and customers; risks of entering markets in which the Company has limited or no prior experience; and potential loss of key employees from either the Company's pre-existing business or the acquired organization. Some or all of these risks could have a material adverse effect on the Company's business, results of operations and financial condition. In addition, there can be no assurance that acquired businesses, products or technologies, if any, will achieve anticipated revenues and income.

Acquisitions could also use a substantial portion of the Company's available cash; may result in the Company incurring substantial debt, which may not be available on favorable terms and may adversely affect the liquidity of the Common Shares; may result in the Company assuming contingent liabilities and taking substantial charges in connection with the impairment of goodwill and amortization of other intangible assets; and may result in the issuance of equity securities that would dilute existing shareholders. The failure of the Company to manage its acquisition strategy successfully could have a material adverse effect on the Company's business, results of operations, liquidity and financial condition.

#### **Distribution Channels in the Interoperability Market**

The Company employs a multi-channel sales and marketing strategy, using direct sales, OEMs, distributors and other resellers to address its global market for its Interoperability products. The Company expects that its Interoperability division will remain dependent upon these parties to distribute its products. In addition, the performance of OEMs, distributors and other resellers is outside the control of the Company, and the Company is unable to predict the extent to which these organizations will be successful in marketing and selling the Company's Interoperability products. The Company's failure to attract and retain sufficient direct sales personnel or to maintain its existing third-party relationships or to establish new relationships with OEMs, distributors and other resellers could have a material adverse effect on the Company's business, results of operations, liquidity and financial condition.

#### **Potential for Undetected Errors in Software**

Software products, as complex as those offered by the Company, often encounter development delays and may contain undetected defects when introduced or when new versions are released. The Company has encountered delays and discovered previously undetected defects in the introduction of new products and product enhancements. There can be no assurance that the Company will not encounter product development delays in the future or that, despite testing by the Company, errors will not be found in new products or product enhancements after commencement of commercial shipments, resulting in damage to the Company's reputation, loss of revenue, loss of market share, delay in market acceptance or warranty claims, any of which could have a material adverse effect upon the Company's business, results of operations, liquidity and financial condition. This risk is amplified for the Company because a portion of its sales have been derived, and are expected in the future to be derived, from arrangements under which third parties embed the Company's products in their own products.

Any significant errors in the Company's products, or in the products of third parties which embed the Company's products, might discourage such third parties or other customers from utilizing the Company's products, which could have a material adverse effect on the Company's business, results of operations, liquidity and financial condition. Although the Company generally attempts to limit by contract its exposure to incidental and consequential damages, if a court failed to enforce the liability limiting provisions of the

Company's contracts for any reason, or if liabilities arose which were not effectively limited, the Company's business, results of operations, liquidity and financial condition could be materially and adversely affected.

#### Protection of Intellectual Property

The Company relies primarily on a combination of copyright, trademark and trade secrets laws, confidentiality procedures and contractual provisions to protect its proprietary rights. Substantial portions of the Company's sales are derived from the licensing of the Company's products under shrink-wrap license agreements that are not signed by licensees and therefore may be unenforceable under the laws of certain jurisdictions. The Company generally enters into confidentiality agreements with its other licensees, employees and third-party distributors. Despite the Company's efforts to protect its proprietary rights, unauthorized parties may attempt to copy and may succeed in copying aspects of the Company's products or to obtain and use information that the Company regards as proprietary. Furthermore, there can be no assurance that others will not independently develop products similar to those of the Company.

In addition, the laws of some foreign countries do not protect the Company's proprietary rights to as great an extent as do the laws of Canada or the United States. There can be no assurance that the Company's competitors will not independently develop similar technology or that the Company's means of protecting its proprietary rights will be adequate, and consequently the Company's business, results of operations, liquidity and financial condition could be materially adversely affected.

The Company is not aware that any of its products infringe the proprietary rights of third parties. There can be no assurance, however, that third parties will not claim infringement by the Company with respect to current or future products. The Company expects that software product developers will increasingly be subject to infringement claims as the number of products and competitors in the ALM and Interoperability markets grow and the functionality of products in these markets overlaps. Defense of such claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays or require the Company to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to the Company or at all, either of which could have a material adverse effect upon the Company's business, results of operations, liquidity and financial condition.

#### Reliance on Third Party Relationships

The Company has a number of third-party relationships that are significant to its marketing, sales and related support activities and product development efforts. The Company relies upon relational database management systems applications, and development tool vendors, software and hardware vendors to strengthen its product offerings through integration with industry-standard tools and utilities. The Company's intent in entering into these relationships is to keep pace with the technological and marketing developments of major software vendors, to acquire technical assistance for the Company's product development efforts and to leverage the Company's sales and marketing capabilities. There can be no assurance that these companies, many of which have significantly greater financial and marketing resources than the Company, will not develop or market software products that compete with the Company's products in the future or will not otherwise discontinue their relationships with or support of the Company. The failure of the Company to maintain its existing relationships, or to establish new relationships in the future, for any reason, could have a material adverse effect on the Company's business, results of operations, liquidity and financial condition.

#### Use of Open Source Software

The Company uses a variety of "open source" and "free-ware" software products in its products that are not maintained or supported by the original developers of such products. The Company has not conducted any independent investigations to determine if the sources of these third party software products have the rights necessary to permit the Company to use these products free of infringement claims by third parties. The Company could possibly be required to replace these third party software products with internally developed or commercially licensed components, which could delay the Company's product development plans or require it to pay licensing fees to third parties.

#### Litigation

The nature of the Company's business subjects the Company to regulatory investigations, claims, lawsuits and other proceedings in the ordinary course of the Company's business. The results of these legal proceedings cannot be predicted with certainty. There can be no assurance that these matters will not have a material adverse effect on the Company's results of operations in any future period, depending partly on the results for that period, and a substantial judgment could have a material adverse impact on the Company's results from operations, liquidity and financial condition.

From time to time, the Company may be required to enforce its rights under contractual arrangements with its customers, including for non-payment of amounts owing. There can be no assurance that the Company will be successful in any such action or that the Company will not incur significant expenses in the course of the litigation or be required to devote a material portion of the Company's management resources to any such action.

#### Concentration of Ownership

The directors and executive officers of the Company as a group beneficially own, directly or indirectly, approximately 25% of the Common Shares outstanding. As a result, these shareholders, if acting together, could have significant influence over matters requiring the approval of the shareholders of the Company, including the election of the Company's Board of Directors and significant transactions. This concentration of ownership may have the effect of delaying or preventing a change in control of the Company or otherwise cause the Company to take action that may not be in the best interests of all shareholders, either of which in turn could reduce the market price per share of the Common Shares.

**Market Maturity in the Interoperability Market**

The Company has, in the past, derived significant growth from its products and services targeted at the Interoperability market. The Interoperability market is now considered by the Company to be mature relative to the other markets that it addresses, and is expected to undergo limited growth. The Company's license revenue from the IO segment has declined in each of the past three fiscal years and the Company expects to experience a continuing decline in license revenue from this segment. The market for Interoperability products and services generally is subject to aggressive competition, resulting in increasing downward pressure on product licensing fees and gross margins. As a result of the relative maturity of the Interoperability market and increasing competition in that market, the Company may be unable to maintain or increase its current level of revenues from its Interoperability products and services, or to achieve the same level of gross margins as it has achieved on the licensing of Interoperability products in the past, each of which may have a material adverse impact on the Company's business, results of operations and financial condition.