



1988 ANNUAL REPORT



COMPANY PROFILE

Relational Technology develops, markets and supports the INGRES family of software products used for database management and application development. Founded in 1980, Relational Technology was a pioneer in relational database management technology and today is a leading supplier of relational database management and application development software to users of DEC VAX computers and minicomputers running UNIX operating systems. The INGRES relational database management system has powerful application development tools that provide users with increased productivity and flexibility in application development. INGRES products are available on mainframes, minicomputers, workstations, and personal computers from major manufacturers such as DEC, AT&T, IBM, Sun Microsystems, Hewlett-Packard, Data General, and International Computers Limited. Relational Technology shares are traded on the NASDAQ under the symbol RELY.

ABOUT THE COVER

Relational Technology's INGRES products are used around the clock, around the world. They are used by major international organizations that have determined that if you take a close look, INGRES is the answer.

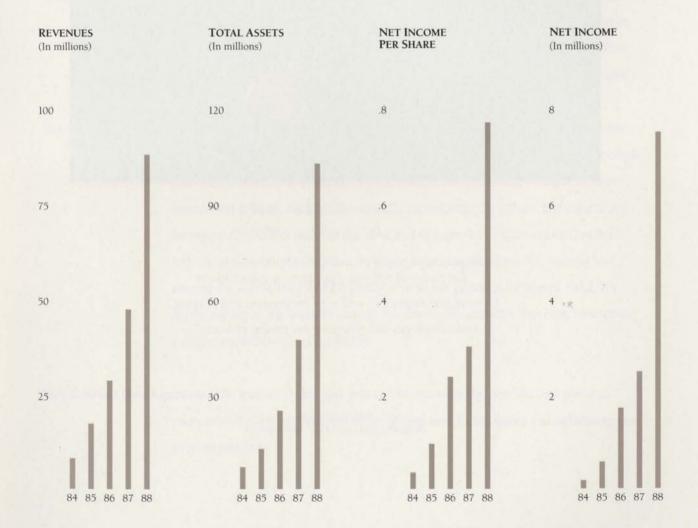
At an aircraft engine manufacturer, INGRES forms the heart of a completely automated computer integrated manufacturing system. This state-of-the-art system links applications such as inventory, finance and personnel with specialized manufacturing software that controls machine tools, material handling equipment, robots and other automated equipment on the factory floor.

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FINANCIAL HIGHLIGHTS

(dollars in thousands, except per share data)	1988	1987	1986	1985	1984
Revenues	\$ 87,386	\$46,565	\$28,138	\$17,271	\$7,585
Operating income	10,850	3,102	2,503	771	218
Net income	7,464	2,477	1,664	555	198
Net income per share	.76	.29	.23	.08	.03
Working capital	37,475	12,355	6,979	1,307	1,470
Total assets	100,966	46,364	24,021	11,634	6,935
Long-term debt	3,692	2,955	2,604	2,145	52
Stockholders' equity	63,844	24,851	13,898	4,746	4,188
Weighted average shares outstanding	9,873	8,456	7,393	6,825	6,083





"The success of this past year can be measured by our financial performance, as well as by our progress in developing new technologies and enhancing our existing products."

PAUL E. NEWTON
PRESIDENT AND CHIEF EXECUTIVE OFFICER

- During fiscal 1988—the most successful year in Relational Technology's eight-year history—revenues and net income reached all-time highs. We expanded our marketing efforts, introduced a new version of our INGRES software, and offered our stock to the public for the first time. These developments, along with the growing acceptance of our products in the relational database marketplace, made fiscal 1988 a landmark year that positions our company for continued profitable growth.
- Relational Technology's revenues increased by nearly 90 percent to \$87.4 million in fiscal 1988, from \$46.6 million in fiscal 1987. Operating margins improved and net income rose sharply to \$7.5 million, or \$.76 per share, compared with \$2.5 million, or \$.29 per share, during fiscal 1987.
- In May 1988, we completed our initial public offering of common stock. The proceeds—\$22.6 million—will be used to fund our aggressive sales, marketing and product development efforts.
- An Expanding Relational Database Market. Relational Technology is at the forefront of the rapidly growing market for relational database management systems. Industry experts estimate that the total market for these systems will grow from approximately \$1.25 billion in 1987 to \$8.0 billion in the early 1990s. In fact, relational database systems now outsell traditional systems by a factor of two-to-one.
- In a business environment that continues to become more and more complex, the need for information management systems that offer both high-speed performance and around-the-clock reliability has never been greater. While older, slower relational database systems found their primary niche in the scientific community, the robust, high-speed performance of INGRES makes it the ideal tool to meet the mission-critical needs of today's commercial marketplace. In major organizations across the country and around the world, the INGRES family of products provides the speed, flexibility and reliability to successfully manage the day-to-day activities that keep businesses running smoothly—and profitably.
- **Key Product Developments.** The success of this past year can be measured by our financial performance, as well as by our progress in developing new technologies and enhancing our existing products.

- INGRES Gateways: In 1988, Relational Technology introduced the first of the INGRES Gateway group of products. INGRES Gateways will enable users to access data easily, from anywhere in their organization. We anticipate that these innovative products will broaden our market opportunities by accelerating the transition from traditional information management systems to the more powerful and flexible relational database technology.
- New INGRES Release: We continued to increase the capabilities and performance of INGRES in 1988. Last March we began initial shipments of INGRES Release 6 for DEC VAX/VMS computers. This new release incorporates technological enhancements that dramatically increase transaction processing performance, and is designed to take advantage of new, high-speed multi-processor computers recently released by DEC and other computer manufacturers.
- Major Performance Breakthrough: In a demonstration of the increased speed of INGRES Release 6, Relational Technology conducted an authenticated, industry-standard benchmark, running a prototype version of INGRES Release 6 on a 16-processor Sequent computer. In the test, INGRES achieved a processing speed of 100 transactions per second—a five-fold increase over previous releases. Release 6 dramatically improves the price/performance ratios offered by INGRES in the information processing marketplace, and firmly positions Relational Technology to take advantage of significant new application markets.
- Sun Microsystems Joint Agreement: In late 1987, Relational Technology signed a joint agreement with Sun Microsystems to develop a new generation of tools for use on intelligent workstations. These tools will employ sophisticated window and mouse technology to give users even easier access to information stored in relational databases.
- **Expanded Sales and Marketing Efforts.** The expansion of Relational Technology's sales and marketing organization continued to be a company priority during 1988. A key contributor to our excellent financial results, these expansion efforts have helped us leverage our recognized technological leadership to increase the company's market share.
- Relational Technology enjoys the loyalty of a large, established customer base comprised of organizations within our primary markets—Fortune 1000 companies, large international corporations, governmental organizations and educational institutions. During 1988,

to better serve these valuable customers and to further build revenues within these markets, we increased substantially both our direct sales force and our telesales organization, which markets INGRES add-on products. The ability of Relational Technology to meet the needs of customers in global markets, backed by our financial strength and technological leadership, gives us tremendous advantages in a market which is projected to continue to expand rapidly.

In the international marketplace—an area of ever increasing importance to Relational Technology—we have continued to expand our marketing activities and sales presence among large multinational corporations. In fact, in fiscal 1988 44% of our total revenues came from international customers.

During 1988, we increased the number of staff devoted to developing and maintaining strategic relationships with original equipment manufacturers (OEMs), value-added remarketers (VARs) and consulting firms. As a result of these key relationships, our products have been selected for remarketing by a number of major manufacturers—including IBM, DEC, Hewlett-Packard, International Computers Limited and Data General.

Looking Ahead. Relational Technology has just concluded its eighth year as a company—and its eighth year of profitability. As we begin our new fiscal year, we are optimistic about both the short- and long-term future. With a focused marketing orientation in a high-growth industry, superb products that meet the information processing needs of customers worldwide, a strong financial foundation and an experienced management team, we believe we are well positioned to attain an even greater share of the expanding relational database market.

In closing, we wish to thank our employees and marketing partners for their contributions to our continuing success, and our new shareholders for the confidence they have placed in us.

We look forward to sharing with you our continued achievements.

Sincerely,

PAUL E. NEWTON

PRESIDENT AND CHIEF EXECUTIVE OFFICER

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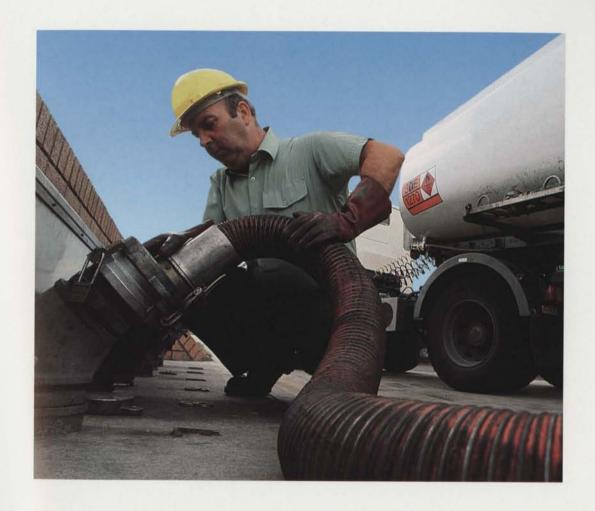
Today, more than ever before, leading organizations around the world rely on computers to maintain their competitive edge. In manufacturing, quality control, design, market analysis, sales and customer service, and new product development, computer technology provides the power to succeed.

Yet even though computers have become commonplace in most organizations, traditional information management technologies have not provided the means to exploit fully this major resource. As a result, more and more organizations are turning to relational database management systems in their efforts to realize the productivity gains made possible by today's computers.

Relational databases dramatically reduce the time and costs associated with developing and deploying computer applications. By providing individuals with the power and flexibility to work faster and smarter, relational databases enable quantum leaps in productivity. Programmers, for example, can develop systems more easily and quickly, and can modify them to meet changing requirements in a fraction of the time it would take using other, less advanced technologies.

In today's business world, keeping ahead of the competition is a direct function of an organization's ability to manage information efficiently, reliably and without overspending. The INGRES family of products directly addresses these fundamental needs by providing:

- The tools to speed up application development and reduce costs;
- · The flexibility to adapt to organizational change and growth;
- The ability to access and work with a broad range of computer and information resources;
- The portability that allows applications to be installed on the most cost-effective hardware systems; and
- The technology to exchange data and applications freely among dissimilar computer systems, as if no differences existed.



Petroleum companies use INGRES application development tools to integrate and access critical information on a corporate-wide basis.

INGRES tools are among the most advanced available for developing major database systems, prototyping applications and creating broad-based computer networks. Major oil and gas producers also rely on INGRES to help them maximize the return on their hardware and software investments.



A regional Bell operating company uses a UNIX-based INGRES application to monitor its coin-operated telephones automatically. Each phone carries its own on-board microcomputer, which makes scheduled calls into the company's INGRES system with status information such as coin capacity and working order. The system has been so successful that the company is now offering this money-saving product for resale to other telecommunications manufacturers.

INGRES' technological excellence has been recognized by leading hardware manufacturers such as Digital Equipment Corporation, IBM, Hewlett-Packard, International Computers Limited and Sun Microsystems—companies that have incorporated INGRES in their product offerings. Many software companies have adopted INGRES as the technological base for their purchased software applications, and provide a wide variety of "ready-to-run" software products to INGRES users. And leading consulting firms such as Ernst & Whinney and Computer Task Group offer specialized INGRES consulting services to help major organizations build and install new INGRES-based applications.

The following explains how INGRES helps major organizations around the world to become more competitive—and stay that way—by harnessing the power of computerized information.

INGRES: The one set of computing tools that makes all the others work better. In today's complex business environment, getting the right information to the right people—when and where they need it—is critical to ongoing success. INGRES application development tools help information managers, end users and application developers to both increase productivity and reduce application backlogs.

Because INGRES products are portable across multiple computer platforms, they make information exchange between users and their computers easier, faster and more efficient than most users ever thought possible. And INGRES runs on today's most widely used computers, including DEC VAX, over 35 UNIX-based machines, IBM mainframes and PCs.

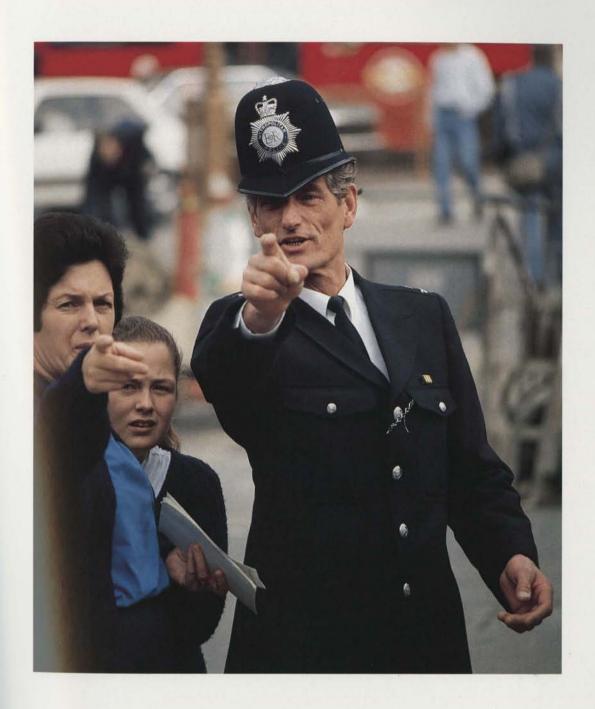
INGRES tools are easy to learn and work with, for both technical and non-technical users. Consistent in look and feel across the board, they enable virtually anyone to perform information queries, create reports and produce informative graphic presentations—without having to learn complex programming techniques.

For professional programmers, INGRES provides an advanced set of tools for application development, prototyping and networking. INGRES also integrates fourth generation language (4GL) and traditional programming languages, saving hundreds of hours of valuable development time.

During the past year, Relational Technology continued to improve its application development tools to provide even higher levels of productivity and performance. In a joint venture with Sun Microsystems, for example, Relational Technology began the development of a new set of mouse- and window-based Structured Query Language (SQL) tools that will make database access even easier. Relational Technology also entered into a strategic relationship with Cadre Technologies Incorporated to develop a sophisticated set of computer-aided software engineering (CASE) tools for use with INGRES. Through partnerships such as these, Relational Technology aims to keep INGRES at the forefront of the fastest growing segments of the relational database market.

From the chief executive office to the shop floor, INGRES is the tie that binds. A growing number of large organizations rely on INGRES to manage everything from payroll, personnel and inventory to "mission critical" applications that enable multiple users to access and update data simultaneously. As the crucial information link between management and the people who keep an organization running on a day-to-day basis, INGRES helps keep both productivity and profitability at the highest levels. In addition, INGRES provides the flexibility to expand to accommodate change and growth.

During 1988, Relational Technology began testing INGRES Release 6 at major customer sites. With its newly designed database "engine," this latest release will enable users to develop departmental and transaction processing systems more quickly and efficiently than ever before. In addition, Release 6 is designed to run on new high-performance, multi-processor computers offered by companies such as Digital Equipment Corporation, IBM and Sequent Computer Systems.



London's Crime Reporting Information System will,
when fully implemented in 1989, link 30,000 police officers and civilian
staff 24 hours a day, seven days a week. As the foundation
of this advanced crime-reporting system, INGRES will manage massive
amounts of distributed data stored in over 230 mini-computers,
providing immediate access to critical crime-fighting information
at over 2,000 police workstations.



Major financial services companies are turning to INGRES information management for the speed, reliability and expandability they need to integrate their existing technologies with powerful new relational systems.

- INGRES erases both the differences and the distance between networked computers. In organizations operating under the pressures of intense competition and rapid change and growth, the ability to share information resources easily—regardless of their location—is vital.
- As the industry leader in distributed database technology, Relational Technology offers the ease and convenience of distributed computing via INGRES distributed data management products.

 These products automatically handle the differences between dissimilar hardware, software and operating environments, providing users with fast, easy and transparent access to data anywhere in their systems—whether from across the hall or around the world.
- The INGRES/STAR distributed data manager helps developers create applications that enable users to access widely distributed data as easily as if it were stored in their own personal computers.
- INGRES/NET provides the connection between different computer systems, helping organizations share information more efficiently, while saving valuable programming time and communications costs.

Last but not least, new INGRES Gateways provide easy access to existing databases and file systems.

- INGRES talks to older and newer technologies with equal ease. Developed and introduced by Relational Technology, INGRES Gateways allow customers to link up with old existing non-relational software. By providing easy access to applications and data already in place, they protect current investments in hardware, training and applications.
- When INGRES applications are integrated into existing environments, they make working with nonrelational data easier than ever. In addition, INGRES Gateways provide an easy "migration path" from older data management tools, allowing organizations to make the transition to more flexible relational systems at their own pace.

In 1988, Relational Technology introduced two gateway products that are helping to make resource sharing a practical reality. The INGRES Gateway to DEC RMS allows users to access data from RMS files for use in INGRES applications. And the INGRES Gateway to Ashton-Tate's dBASE III lets users access data from one of the most popular database products for personal computers.

In the future, Relational Technology plans to introduce INGRES Gateways for other widely used products, such as IBM's IMS and DB2 and DEC's RDB database system—solutions that will provide organizations with even greater strategic computing advantages.

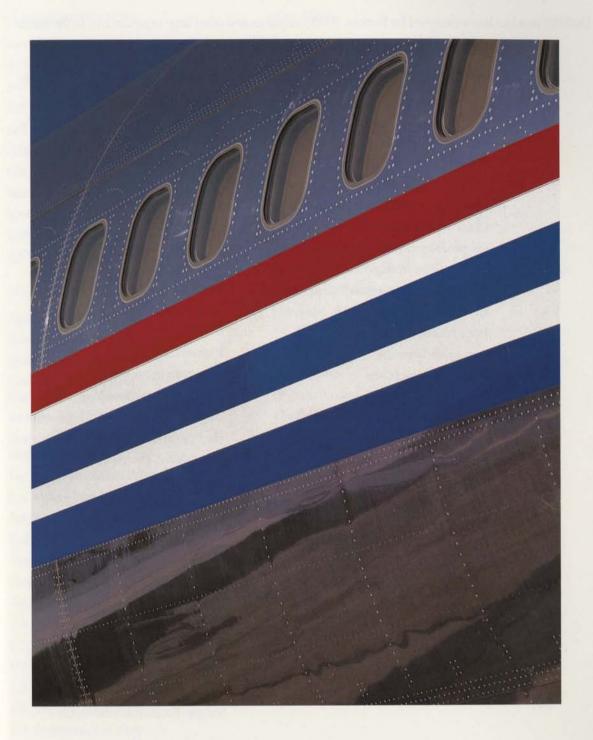
INGRES' strategic partnerships provide more computing options and access to a wide variety of

systems. Relational Technology has entered into strategic partnerships with a rapidly growing list of third-party vendors whose products complement INGRES. Over the last five years, for example, Relational Technology has allied itself with many industry leaders, including OEMs such as Digital Equipment Corporation, AT&T, IBM, Sun Microsystems, Hewlett-Packard, Data General, International Computers Limited and Sequent Computer Systems.

Relational Technology also works in close partnership with over one hundred INGRES value-added remarketers (VARs) who use INGRES as the DBMS platform for building ready-made applications. These off-the-shelf products meet a wide variety of customer needs, including accounting, defense, project management, component testing, process control, publishing, manufacturing and many others.

Relational Technology also announced new joint marketing agreements with Access Technology, Cadre

Technologies Incorporated and Natural Language Incorporated that will enable users
to work with INGRES data using spreadsheets, sophisticated CASE products and
English-language query tools.



INGRES distributed relational database management components are integral to the core of the application software engineering process used in the design and manufacture of commercial and military aircraft. INGRES helps improve productivity and streamline the exchange of information in a variety of areas, from design engineering to computer integrated manufacturing.

The INGRES product line is designed for Fortune 1000 companies and other large organizations in the manufacturing, finance, telecommunications, government and education sectors. The company's customers include the following entities or their divisions or subsidiaries:

MANUFACTURING/INDUSTRIAL

The Boeing Company

Burlington Northern Railroad

Celanese Corporation

Champion International Corporation

Chrysler Corporation

Colgate-Palmolive Co.

Corning Glass Works

E. I. duPont de Nemours and Company

Eastman Kodak Company

Firestone Tire & Rubber Co.

Ford Motor Company

General Dynamics Corp.

General Electric Company

General Motors Corporation

Honeywell, Inc.

Hughes Aircraft Company

ICI Pharmaceuticals P.L.C.

Intergraph Corp.

L'Oreal Group

Lockheed Corporation

Martin Marietta Corporation

Minnesota Mining and

Manufacturing Corporation

Nestle S.A.

Northrop Corporation

Philips Industries, N.V.

Polaroid Corporation

Raytheon Co.

Reuters Limited

Schlumberger N.V.

Scott Paper Co.

Siemens A.G.

Smith Kline Beckman Corporation

TRW Inc.

Tektronix, Incorporated

Texas Instruments Incorporated

Unisys Corporation

United Technologies Lexar Corporation

The Upjohn Company

Westinghouse Electric Corporation

FINANCE

Aetna Life & Casualty Co.

Alexander & Alexander, Inc.

Citicorp

Corroon & Black Corporation

Eastern Airlines Credit Union

J. P. Morgan & Co. Incorporated

Lloyds Bank

London Stock Exchange

Midland Bank

Security Pacific Automation Co.

TELECOMMUNICATIONS

Alcatel

AT&T Co.

Bell Canada

Bell Communications Research, Inc.

Bell South Services, Inc.

British Telecommunications

GEC Telecom

Northwestern Bell Telephone Co.

Southwestern Bell Telephone Co.

US West Advanced Technologies

US West Communications

GOVERNMENT

Agriculture Canada

Canada Postal Corp.

Deutsche Bundespost

Government of Ontario, Ministry of

Community and Social Services

Jet Propulsion Laboratory

Lawrence Livermore

National Laboratory

London Metropolitan Police

Los Alamos National Laboratory

NASA

Norsk Hydro A/S

Queensland State Government

Sandia National Laboratory

U.K. National Health Service

U.K. Navy

U.S. Department of Air Force

U.S. Department of Army

U.S. Department of Defense

U.S. Department of Interior

U.S. Department of Navy

U.S. Postal Service

EDUCATION

Boston University

Carnegie Mellon University

The Johns Hopkins University

London School of Economics

Massachusetts Institute

of Technology

New York University

Northwestern University

Princeton University

University of California, Berkeley

University of Colorado

University of Michigan

University of North Carolina

University of Wisconsin

PETROLEUM PRODUCTS

Amoco Corp.

BP America, Inc.

The British Petroleum Company p.l.c.

Chevron Corporation

Conoco, Inc.

Sun Exploration & Production Co.

The Company was founded in July 1980 and shipped its first product in June 1981. Since that time the Company's revenues and income have substantially increased each year. In the past three fiscal years, the Company has placed increasing emphasis on sales and marketing and has expanded its product line and the geographical scope of its operations. During this period, research and development and general and administrative expenses have declined as a percentage of revenues. For the year ended June 30, 1988, revenues increased to \$87.4 million from \$46.6 million in the prior year, and net income tripled.

RESULTS OF OPERATIONS

The following table sets forth for the fiscal period indicated, (a) the percentage of revenues represented by certain items in the Company's consolidated statements of income, and (b) the percentage increase in such items from the prior fiscal period.

tiscal period.	Fiscal Years Ended June 30,		Fiscal 1988 Compared to	Fiscal 1987 Compared to	
	1988	1987	1986	Fiscal 1987	Fiscal 1986
Revenues:	02.00/	87.9%	90.0%	79%	62%
Licenses	83.8% 16.2	12.1	10.0	151	100
Maintenance	10.2				1000
Total revenues	100.0	100.0	100.0	88	65
Operating expenses:	- CO 10	60.0	47.8	94	111
Sales and marketing	62.8	60.8	32.7	41	13
Research and development(1)	16.8	22.4	10.6	47	58
General and administrative	8.0	10.2	10000		
Total operating expenses	87.6	93.4	91.1	76	70
Operating income	12.4	6.6	8.9	250	24
Interest income	1.5	1.7	.4	70	469
Interest expense	(0.7)	(1.2)	(1.4)	15	40
Foreign exchange gain (loss)	0.9	1.4	(.1)	33	*
Income before income taxes	14.1	8.5	7.8	213	79
Provision for income taxes	5.6	3.2	1.9	232	172
Net income	8.5%	5.3%	5.9%	201%	49%

⁽¹⁾ The Company capitalized software development costs equal to 4.5% and 6.1% of revenues during fiscal 1988 and 1987, respectively.

REVENUES

The Company's revenues increased 65% from fiscal 1986 to fiscal 1987 and 88% from fiscal 1987 to fiscal 1988, reflecting continued increases in the number of customers and installations of the Company's products. Additionally, the increase is attributable to the continuing expansion of the market for relational database management systems (DBMS), which is reflected in significant sales to new customers, particularly international customers, as well as continued sales to the existing customer base. Prior to fiscal 1987, the Company typically priced its relational DBMS and application development tools as a single package. A portion of the revenue increase in fiscal 1987 resulted from price increases associated with the unbundling of these products.

During the past three fiscal years, the Company's product and customer base has expanded significantly as the Company has increased the types of computers and operating systems on which its INGRES products operate. However, licenses for use on DEC VAX computers have continued to represent a substantial portion of the license revenues in each of the past three fiscal years.

Revenues from international customers were approximately 31%, 35% and 44% of the Company's revenues in fiscal 1986, 1987 and 1988, respectively, reflecting increased acceptance of the Company's products internationally. The Company expects its international operations to continue to represent a significant portion of total revenues.

The Company provides ongoing maintenance services, which include technical support and product updates, for an annual fee. As the Company's existing customer base has expanded, maintenance revenues have increased steadily from 10% of revenues in fiscal 1986 to 12% of revenues in fiscal 1987 and 16% of revenues in fiscal 1988. Maintenance revenues have provided a source of recurring revenues and reflect the cumulative growth of the Company's customer base. Substantially all of the Company's customers enter into and renew annual maintenance contracts. Revenues from maintenance contracts are recognized ratably over the annual maintenance period.

^{*}Not meaningful.

OPERATING EXPENSES

Sales and Marketing Expenses. Beginning in the second half of fiscal 1986, the Company significantly increased its emphasis, both domestically and internationally, on direct sales through its own sales force. Expansion of the Company's sales offices and staff involve substantial initial costs that are not immediately offset by revenue growth. Sales and marketing expenses increased substantially from 48% of revenues in fiscal 1986 to 61% and 63% of revenues in fiscal 1987 and 1988, respectively, as the Company invested heavily in sales and marketing and customer support. The Company believes that substantial sales and marketing expenditures are essential to revenue growth and to maintaining and enhancing the Company's competitive position. Accordingly, the Company expects these expenses will continue to constitute its most significant operating expense.

Research and Development Expenses. The Company believes that the enhancement of existing products and the development of new products is essential to maintaining its competitive position. Accordingly, the Company is committed to a high level of research and development expenditures. The Company's expenditures for research and development increased 43% from fiscal 1986 to fiscal 1987 and 40% from fiscal 1987 to fiscal 1988 (excluding the impact of amounts capitalized). These increases resulted largely from similar percentage increases in the number of research and development personnel. During fiscal 1986, 1987 and 1988, research and development expenses were approximately \$9.2 million, \$10.4 million and \$14.7 million, respectively, representing 33%, 22% and 17% of the Company's revenues in such years.

Prior to fiscal 1987, the Company followed the prevailing practice of charging to expense all research and development expenditures as incurred. The Financial Accounting Standards Board, in its Statement of Financial Accounting Standards (SFAS) No. 86, "Accounting for the Costs of Computer Software to be Sold," now provides that, once technological feasibility has been established, all subsequent software development costs incurred up to the time the product is available for general release to customers be capitalized and reported at the lower of unamortized cost or net realizable value of the product. Accordingly, in fiscal 1987 and 1988, the Company capitalized approximately \$2.8 million and \$3.9 million of software development costs, representing approximately 21% in each year of total research and development expenditures.

The amount of product development expenditures required to be capitalized under SFAS No. 86 in future periods is dependent upon both the level of expenditures incurred on projects that meet the feasibility tests specified in SFAS No. 86 and the timing of the release of the completed products to the Company's customers. Accordingly, amounts required to be capitalized may vary significantly from period to period and could increase or decrease as a percentage of total research and development expenditures.

General and Administrative Expenses. Significant additions to administrative resources have been required to support growth. However, the Company has achieved economies of scale as it has grown, and general and administrative expenses have increased at a substantially lower rate than revenues. Such expenses were 11%, 10% and 8% of revenues in fiscal 1986, 1987 and 1988, respectively.

INCOME

Operating income in fiscal 1986 was \$2.5 million (9% of revenues), compared with \$3.1 million in fiscal 1987 (7% of revenues) and \$10.9 million in fiscal 1988 (12% of revenues). Profit margins in fiscal 1986 were favorably affected by the impact of certain large license agreements completed in the latter half of the fiscal year. The decrease in income as a percentage of revenues from fiscal 1986 to fiscal 1987 was primarily attributable to substantially higher sales and marketing expenses associated with the expansion of the Company's domestic and international sales and marketing efforts. In fiscal 1988, the Company continued to invest heavily in its sales and marketing programs. Revenue increases, combined with reduced operating expense ratios in research and development and general and administrative costs, resulted in substantial increase of operating income.

The Company believes that its investment in key personnel as well as its continued investment in its sales and marketing organization are necessary to achieve its objective of improved long-term profitability. However, there can be no assurance that higher levels of profitability will occur due to the difficulty of predicting revenues and the number of factors that can adversely affect operating results.

In addition to the factors discussed above, the Company's net income for fiscal 1987 and 1988 was favorably impacted by increased net interest income. Net interest income increased as a result of the investment of proceeds from the initial public offering and preferred stock offerings as well as from an increase in interest recognized on long-term accounts receivable (net interest income was \$215,000 in fiscal 1987 and \$672,000 in fiscal 1988 compared to net interest expense of

\$260,000 in fiscal 1986). Foreign exchange gains of \$635,000 and \$842,000 in fiscal 1987 and 1988, respectively, compared to nominal amounts in prior years also favorably impacted net income. The Company's net income has also been affected by changes in the effective income tax rate, which has increased from 25% and 37% in fiscal 1986 and 1987, respectively, to 40% in fiscal 1988.

In December 1987, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 96, "Accounting for Income Taxes." SFAS 96 mandates the liability method for computing deferred income taxes. Adoption of the new Statement is not expected to have a significant effect on the Company's financial position or results of operations.

Historically, the Company's revenues have increased in each sequential quarter during a fiscal year, although they have declined in the first fiscal quarter of each year from the final quarter of the preceding year. The Company believes that continued investment in personnel and facilities is essential to achieving revenue growth. Because a significant training period is required before sales and marketing personnel reach full productivity, expenses related to hiring and training precede revenues generated by such personnel. During each fiscal year prior to fiscal 1988, revenues increased substantially in the third and fourth quarters as investments made during previous quarters in operating costs, particularly those related to the hiring and training of sales and marketing personnel, generated increased revenues. Additionally, the Company's sales commission plan, which rewards the sales force with higher commission rates as they progress toward achieving annual sales quotas, historically tended to concentrate revenues during the second half of the fiscal year. Consequently, the Company has historically achieved greater profitability in its third and fourth quarters. Although the Company has recently achieved profitability in its first and second quarters of each fiscal year will continue to show relatively weaker operating results than each of the other quarters, and may again show losses.

The Company's quarterly results of operations are difficult to predict and delays in product delivery or in closings of sales near the end of the quarter could cause quarterly revenues and, to a greater degree, net income to fall substantially short of anticipated levels. As operating expenses continue to increase, any significant shortfall in quarterly revenues may lead to an operating loss for the quarter. The Company's revenues occur predominantly in the third month of each fiscal quarter, and tend to be concentrated in the latter half of that third month.

From time to time, the Company has earned substantial revenues from large software license agreements. The impact of these large license agreements can cause significant fluctuations in quarter-to-quarter results of operations. Similar fluctuations may continue to occur in the future.

Quarterly net income during fiscal 1988 was also impacted by foreign exchange gains and losses. See "Income." Quarterly pretax foreign exchange gains (losses) for fiscal 1988 were \$45,000, \$1,298,000, (\$223,000) and (\$278,000), respectively.

INFLATION

Inflation has not had a significant impact on the Company's results of operations.

LIQUIDITY AND CAPITAL RESOURCES

In May 1988, the Company raised net proceeds of approximately \$22.6 million at its initial public offering. Part of the proceeds were used to pay international lines of credit of \$1.3 million and a domestic term loan of \$2.0 million. Historically, the Company has funded its growth through the sale of Preferred Stock, internally generated funds and bank borrowings. Working capital has increased from \$7.0 million at the end of fiscal 1986 to \$12.4 million at the end of fiscal 1987 to \$37.5 million at the end of fiscal 1988. At June 30, 1988, the Company had an \$8 million revolving line of credit, and a \$3 million capital equipment line of credit. No amounts were outstanding under either of these agreements at June 30, 1988. These domestic lines of credit expire in October 1988. In addition, the Company also has foreign overdraft facilities and secured lines of credit that aggregate \$2.2 million under which no amount was outstanding at June 30, 1988. The Company is in compliance with the applicable financial covenants under each of its lines of credit. As of June 30, 1988, cash and cash equivalents aggregated \$23.8 million. The principal foreign line of credit expires in April 1989.

The Company believes that the remaining net proceeds from its initial public offering, together with existing cash resources, available borrowings under its lines of credit and internally generated funds, will be sufficient to meet its anticipated working capital and capital expenditure requirements through at least the end of fiscal 1989. The Company had no material commitments for capital expenditures as of June 30, 1988.

OUARTERLY RESULTS OF OPERATIONS

The following table sets forth selected unaudited quarterly financial information for the Company's last 12 fiscal quarters. The Company believes that all necessary adjustments have been included in the amounts stated below to present fairly the selected quarterly information when read in conjunction with the financial statements included elsewhere herein.

				Fiscal 1988
(in thousands, except per share data)	Sept. 30, 1987	Dec. 31, 1987	Mar. 31, 1988	June 30, 1988
Revenues	\$16,203	\$18,737	\$22,240	\$30,206
Operating expenses: Sales and marketing Research and development ⁽¹⁾ General and administrative	10,451 3,084 1,405	12,476 3,257 1,604	14,292 3,747 1,766	17,655 4,631 2,168
Total operating expenses	14,940	17,337	19,805	24,454
Operating income	\$ 1,263	\$ 1,400	\$ 2,435	\$ 5,752
Net income	\$ 816	\$ 1,697	\$ 1,404	\$ 3,547
Net income per share ⁽²⁾	\$.09	\$.18	\$.15	\$.32
Number of shares used in computation	9,300	9,271	9,665	11,110
				Fiscal 1987
(in thousands, except per share data)	Sept. 30, 1986	Dec. 31, 1986	Mar. 31, 1987	June 30, 1987
Revenues	\$8,498	\$8,701	\$12,048	\$17,318
Operating expenses: Sales and marketing Research and development ⁽¹⁾ General and administrative Total operating expenses Operating income (loss) Net income (loss) Net income (loss) per share ⁽²⁾ Number of shares used in computation	5,057 2,118 843 8,018 \$ 480 \$ 159 \$.02 8,227	6,012 2,512 1,018 9,542 \$ (841) \$ (377) \$ (.04)	7,547 2,757 1,430 11,734 \$ 314 \$ 557 \$.07	9,696 3,036 1,436 14,168 \$ 3,150 \$ 2,138 \$.25
	, The reliable			Fiscal 1986
(in thousands, except per share data)	Sept. 30, 1985	Dec. 31, 1985	Mar. 31, 1986	June 30, 1986
Revenues	\$4,721	\$5,165	\$7,772	\$10,480
Operating expenses: Sales and marketing Research and development(1) General and administrative	2,456 1,998 543	2,907 2,210 659	3,461 2,355 754	4,626 2,635 1,031
Total operating expenses	4,997	5,776	6,570	8,292
Operating income (loss)	\$ (276)	\$ (611)	\$1,202	\$ 2,188
Net income (loss)	\$ (248)	\$ (461)	\$ 785	\$ 1,588
Net income (loss) per share ⁽²⁾	\$ (.04)	\$ (.06)	\$.11	\$.21
Number of shares used in computation	7,029	7,449	7,384	7,724

⁽¹⁾ Beginning with fiscal 1987, the Company has applied SFAS No. 86, under which the Company capitalized software development costs of approximately \$653,000, \$747,000, \$761,000, and \$667,000, in the first, second, third and fourth quarters of fiscal 1987 and \$735,000, \$834,000, \$955,000 and \$1,410,000 in the first, second, third and fourth quarters of fiscal 1988, respectively.

(2) The sum of not income now deep for the four quarters of a fiscal year does not equal the approal amount as reported on the consolidated statements of income, due to the

third and fourth quarters of fiscal 1988, respectively.

(2) The sum of net income per share for the four quarters of a fiscal year does not equal the annual amount as reported on the consolidated statements of income, due to the larger amount of net income reported in the fourth quarter relative to the first three quarters for all periods presented, as well as the impact of the initial public offering on the weighted average shares for the fourth quarter of fiscal 1988.

RELATIONAL TECHNOLOGY, INC CONSOLIDATED BALANCE SHEETS

		June 30,
(dollars in thousands)	1988	1987
ASSETS		
Current assets:	* 22.047	£ 2.520
Coch and cash equivalents	\$ 23,847	\$ 2,538
Trade and current instalment receivables (less allowance for doubtful accounts of	20.025	21 774
\$1,380 and \$674)	39,835	21,774
Prepaid expenses and other current assets	4,323	3,817
Total current assets	68,005	28,129
Property and equipment, net	16,172	9,973
Computer software development costs, net	6,463	2,762
Long-term trade receivables	10,326	5,500
	\$100,966	\$46,364
Total assets	\$100,500	===
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 5,925	\$ 3,514
Notes payable to bank and current portion of long-term debt	1,254	1,461
Deferred revenue	9,578	5,612
Accrued employee compensation	6,742	2,815
Income taxes payable	4,524	453
Other current liabilities	2,507	1,919
Total current liabilities	30,530	15,774
	3,692	2,955
Long-term debt, less current portion Deferred income taxes	2,900	2,784
TOTAL SECURITY CONTROL	37,122	21,513
Total liabilities	37,122	21,515
Commitments (Note 5)		
Stockholders' equity:		
Preferred stock, \$.001 par value, authorized 5,000,000 shares; 2,857,432 shares issued		10.554
and outstanding at June 30, 1987	_	19,554
Common stock \$ 001 par value authorized 25,000,000 shares; 10,732,834 and	52 120	563
3,218,783 shares issued and outstanding at June 30, 1988 and 1987, respectively	52,138	(100)
Note receivable from issuance of common stock to officer	12 200	4,834
Retained earnings	12,298	7,007
Foreign currency translation adjustment	(592)	21200
Total stockholders' equity	63,844	24,851
Total liabilities and stockholders' equity	\$100,966	\$46,364
iotal habilities and stockholders equity	Will to though the said	

VARIA SINCE A STATE OF THE STAT	For the Year Ended June			
(dollars in thousands, except per share data)	1988	1987	1986	
Revenues:				
Licenses	\$73,201	\$40,916	625 210	
Maintenance	14,185	5,649	\$25,318 2,820	
Total revenues	87,386	46,565	28,138	
Operating expenses:				
Sales and marketing	54,874	28,313	13,450	
Research and development	14,719	10,423	9,198	
General and administrative	6,943	4,727	2,987	
Total operating expenses	76,536	43,463	25,635	
Operating income	10,850	3,102	2,503	
Interest income	1,309	768	135	
Interest expense	(637)	(553)	(395)	
Foreign exchange gain (loss)	842	635	(37)	
Income before income taxes	12,364	3,952	2,206	
Provision for income taxes	4,900	1,475	542	
Net income	\$ 7,464	\$ 2,477	\$ 1,664	
Net income per share	\$.76	\$.29	\$.23	
Weighted average shares of common stock and common stock equivalents used in computation of net income per share	9,873	8,456	7,393	

RELATIONAL TECHNOLOGY, INC. CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

	Prof	erred Stock	Com	mon Stock	Note Receivable from Issuance of Common	Retained	Foreign Currency Translation	
(dollars in thousands)	Shares	Amount	Shares	Amount	Stock	Earnings	Adjustment	Total
Balance, June 30, 1985	1,122,000	\$ 3,741	3,114,025	\$ 300		\$ 693	\$ 12	\$ 4,746
Issue of Series D Preferred stock	432,000	2,700						2,700
Issue of Series E Preferred stock Issue of common stock under employee	478,540	4,688						4,688
incentive stock option plan			15,548 107,334	12 161	\$(100)			12 61
Issue of common stock Repurchase of common stock			(68,918)	(10)		1 661		(10) 1,664
Net income Foreign currency translation						1,664	37	37
adjustment		THE PERSON NAMED IN			(100)	2.257	49	13,898
Balance, June 30, 1986 Issue of Series E	2,032,540	11,129	3,167,989	463	(100)	2,357	19	8,425
Preferred stock Issue of common stock	824,892	8,425						
under employee stock option plans Issue of common stock			87,319 2,181	100 5				100
Repurchase of common stock			(38,706)	(5)		2,477		(5) 2,477
Net income Foreign currency translation						2,111	(49)	(49)
adjustment					(100)	4.024	(12)	24,851
Balance, June 30, 1987 Issue of Series F	2,857,432	19,554	3,218,783	563	(100)	4,834	-	9,341
Preferred stock Issue of common	800,000	9,341						
stock in initial public offering Issue of common stock			1,800,000	22,593				22,593
under employee stock option plans			69,224	88				88
Repurchase of common stock Conversion of			(605)	(1))			(1)
preferred shares into common stock	(3,657,432)	(28,895)	5,645,432	28,895				-
Repayment of note receivable					100	7,464		100 7,464
Net income Foreign currency						7,757.1		
translation adjustment							(592)	(592
Balance, June 30, 1988			10,732,834	\$52,138		\$12,298	\$(592)	\$63,844

RELATIONAL TECHNOLOGY, INC. CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

(dollars in thousands)	100	For the Year	Ended June 30
Not each would die / 15 X	1988	1987	1986
Net cash provided by (used for) operations: Net income			
	\$ 7,464	\$ 2,477	\$ 1,664
Charges (credits) to income not involving cash:			Ψ 1,001
Depreciation and amortization expense	4,194	2,718	1,713
Deferred income taxes	(35)	999	468
Deferred revenue	3,966	3,372	1,060
Increase (decrease) in cash due to changes in:			1,000
Trade and current instalments receivable	(18,061)	(10,775)	(5,897
Prepaid expenses and other current assets	(355)	(1,321)	(908)
Accounts payable	2,411	2,152	515
Accrued employee compensation	3,927	1,347	496
Income taxes payable	4,071	453	(34)
Other current liabilities	588	765	969
Cash provided by operations	8,170	2,187	46
Net cash provided by (used for) investing activities:			
Property and equipment additions	(10,160)	(5,237)	(2.020)
Computer software development costs	(3,934)	(2,828)	(3,838)
Long-term trade receivables	(4,826)	(2,963)	(2.20%)
Other assets	(1,020)	(2,903)	(2,307)
	(10.020)		17
N- 1 11 / 16 86 1	(18,920)	(10,964)	(6,128)
Net cash provided by (used for) funding activities:			
Increase in debt	10,224	6,327	4,114
Decrease in debt	(9,694)	(5,344)	(4,353)
Issuance of preferred stock	9,341	8,425	7,388
Issuance of common stock, net of repurchases and conversion			
of preferred stock	22,680	100	63
Repayment of note receivable from issuance of common stock	100	_	_
Foreign currency translation adjustment	(592)	(49)	37
	32,059	9,459	7,249
ncrease in cash and cash equivalents	\$ 21,309	\$ 682	\$ 1,167

NOTE 1 THE COMPANY AND SUMMARY OF ITS SIGNIFICANT ACCOUNTING POLICIES

Relational Technology, Inc. (the Company) was incorporated in July 1980 to develop and market relational database computer software and to provide technical support for its products. In May 1988, the Company reincorporated in Delaware and completed an initial public offering of its common stock (See Note 7—Common Stock).

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries after elimination of all significant intercompany accounts and transactions.

Revenue Recognition

Revenue is generated from product licenses and maintenance services.

License revenues include fees from direct license agreements with customers, royalties from license agreements with original equipment manufacturers and other distributors and fees from contracts to develop new products.

Generally, revenue from direct licenses of off-the-shelf software is recognized at contract signing. Revenue is deferred and recognized upon shipment if the product is not available, nonstandard payment terms exist, or delays in post license support activity are included in the license agreement.

Royalty revenue primarily results from minimum royalty guarantees; such revenue is recognized upon contract signing provided that there are no contingencies of contractual commitments yet to be performed by the Company. In cases where there are further contractual commitments, revenue is deferred until all commitments are satisfied. Royalties may also be received based upon individual sales; these royalties are recorded upon notification by the vendor.

Revenue from development contracts is recognized using the percentage of completion method. There were no material unbilled amounts on development contracts as of June 30, 1988, 1987 and 1986.

Instalment contracts are recorded at their present value based upon the Company's effective borrowing rate.

Maintenance revenues include technical support and update fees. Such fees are recognized ratably over the year to which they relate.

Foreign Currency Translation

Assets and liabilities are translated at the foreign exchange rates in effect at the balance sheet date. Revenues and expenses for the year are translated at the average exchange rates in effect during the year. Translation gains and losses are not included in determining net income, but are accumulated and reported as a separate component of stockholders' equity. Foreign currency transaction gains and losses are reflected in the income statement.

Property and Equipment

Property and equipment, including assets held under capital leases, are stated at cost. Depreciation of computer equipment acquired to perform specific development contracts, which has limited other uses, is computed using the double declining-balance method and an estimated useful life of five years. Depreciation of all other assets is computed using the straight-line method and an estimated useful life of five years, or the lease term if shorter. Amortization of leasehold improvements is computed using the shorter of the remaining lease term or the estimated useful life of the respective assets.

Nonmonetary Transactions

Nonmonetary exchanges of software licenses or royalties for hardware or software are recorded in revenue and equipment at the fair value of the item exchanged or received, whichever is more readily determinable.

Software Development Costs

Effective July 1, 1986, the Company began capitalizing software development costs in accordance with Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed." Prior to July 1, 1986, all such costs were charged to expense in the period incurred. Software costs capitalized in the years ended June 30, 1988 and 1987 were \$3,934 and \$2,828, respectively. Amortization of capitalized computer software costs begins when the products are available for general release to customers and is computed on a product-by-product basis over periods not exceeding five years. Amortization expense for the years ended June 30, 1988 and 1987 was \$233 and \$66, respectively. The net effect of this change in accounting principle was to increase income before taxes by \$3,701 and \$2,762, and net income by \$2,132 (\$.22 per share) and \$1,686 (\$.20 per share) for the years ended June 30, 1988 and 1987, respectively.

Income Taxes

Deferred income taxes are provided for timing differences between pretax accounting income and taxable income. Deferred United States income taxes are not provided for undistributed earnings of foreign subsidiaries when such earnings are considered permanently invested in the foreign subsidiaries. Investment tax credits reduced the provision for income taxes in the year the related property was placed in service.

Net Income Per Share

Net income per share is computed using the weighted average number of Common Stock and Common Stock equivalent shares outstanding during the related period. Common equivalent shares consist of stock options. In addition, the calculation also includes the effect of Preferred Stock as if such stock were converted to Common Stock on its respective original dates of issuance. As described in Note 6, conversion of all outstanding Preferred Stock occurred prior to June 30, 1988.

Pursuant to rules of the Securities and Exchange Commission, Common Stock issued by the Company during the twelve months immediately preceding the Company's initial public offering of stock in May 1988, plus the number of common equivalent shares which were granted during the same period pursuant to stock option plans, have been included in the calculation of common and common equivalent shares as if they were outstanding for all periods prior to the offering date.

Reclassification

The Consolidated Balance Sheet as of June 30, 1987 has been reclassified to conform with the financial presentation contained in Relational Technology, Inc.'s 1988 Annual Report.

NOTE 2 PROPERTY AND EQUIPMENT

PROPERTY AND EQUIPMENT		June 50,
	1988	1987
Computer equipment	\$15,217	\$10,925
Computer equipment	6,788	3,057
Furniture, fixtures and equipment	3,321	1,564
Leasehold improvements		-
	25,326	15,546
Accumulated depreciaton and amortization	(9,154)	(5,573)
	\$16,172	\$ 9,973

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Depreciation and amortization expense was \$3,961, \$2,652 and \$1,713 in 1988, 1987 and 1986, respectively.

NOTE 3 LONG-TERM ACCOUNTS RECEIVABLE

The Company has entered into long-term licensing and development contracts which allow for payments on an instalment basis. Long-term receivables at June 30, 1988 mature as follows: in fiscal year 1990—\$6,705; 1991—\$4,325; 1992-\$3,136; 1993 and thereafter-\$300.

NOTE 4 DEBT FINANCING

Long-Term Debt		June 30,
	1988	1987
Term loans payable to bank, interest at prime plus 1/2%, principal and interest payable monthly through 1991	16	\$2,597
Capital leases (Note 5)	\$4,946	1,497
Instalment notes, due at various dates through November 1988, secured by equipment, interest at 12% to 20%, payable in monthly instalments		49
payable in interior, or	4,946	4,143
Current maturities	(1,254)	(1,188)
Current maturities	\$3,692	\$2,955
Long-term debt	===	2000000

Lines of Credit

The Company has an \$8 million domestic bank revolving line of credit bearing interest at .25% above prime and a \$3 million equipment financing line of credit bearing interest at .50% above prime. Any amounts borrowed before October 31, 1988 under the equipment financing line of credit will be payable in equal monthly instalments through October 31, 1992. The Company is required to maintain various financial ratios including minimum working capital of \$8 million; minimum ratio of tangible net worth to total debt of 1-to-1; minimum tangible net worth of \$24 million through June 30, 1988 and \$26 million thereafter; and certain profitability measures. At June 30, 1988, there were no amounts outstanding under either the revolving line of credit or the equipment financing line of credit. Both lines of credit expire in October 1988.

The Company also has international lines of credit aggregating \$2,205 which bear interest based on local market conditions (typically above prime). At June 30, 1987, \$273 was outstanding under these agreements; there were no amounts outstanding at June 30, 1988.

The term loans and domestic and international lines of credit are secured by all of the Company's receivables and fixed assets not otherwise pledged.

NOTE 5 LEASING ARRANGEMENTS

The Company leases its corporate headquarters and sales offices under noncancelable operating lease agreements which expire at various dates through 2010. The lease for the Company's headquarters contains an option to extend the term for an additional five years commencing on July 1, 1992. If the term is not extended, the Company is obligated to pay a \$407 cancellation fee. Most of the leases require the Company to pay property taxes, insurance and maintenance expenses. Several of the leases are subject to escalation provisions, based on changes in the consumer price index, at various times during the terms of the leases. Rental expense under operating leases, including month-to-month facilities and equipment rentals, was \$5,938, \$3,504 and \$1,980, in 1988, 1987 and 1986, respectively.

Minimum future lease payments under the terms of operating leases as of June 30, 1988 are \$6,829—1989; \$7,063—1990; \$6,323—1991; \$5,438—1992; \$4,507—1993 and \$15,391 for 1994 and thereafter. Included in operating lease payments for 1993 and 1994 and thereafter are payments of \$1,834 and \$7,335, which assumes the exercise of the corporate headquarters lease option described above.

The Company has entered into capital lease agreements for computer equipment and furniture, fixtures and equipment, which are accounted for as the acquisition of an asset and the incurrence of a liability. The lease agreements are secured by the leased equipment and are for noncancelable terms of three to five years, during which the Company is required to pay all taxes, insurance and normal maintenance and repairs. Assets held under capital leases included in the property and equipment amounts in Note 2 are as follows:

	J	June 30
	1988	1987
Computer equipment Furniture, fixtures and equipment	\$3,952 2,056	\$1,798
Less — accumulated amortization	6,008 (937)	1,798
	\$5,071	\$1,564
Year Ended June 30: 1989 1990 1991 1992 1993 Thereafter		\$1,789 1,765 1,350 697 489
Total minimum lease payments Amount representing interest		594 6,684
Present value of minimum lease payments Current maturities		(1,738) 4,946
Long-term obligations under capital leases		(1,254)
	3	13,092

NOTE 6 PREFERRED STOCK

The Company is authorized to issue 5,000,000 shares of convertible Preferred Stock. The Company currently has no preferred stock outstanding.

The Company has issued preferred shares as follows (all of which has been converted to common stock as described below):

	Preferred Series	Shares Issued	Price Per Share	Proceeds, Net of Issuance Costs
Year Ended June 30:				
1981	A	305,000	\$ 1.00	\$ 305
1982	В	192,000	5.00	936
1984	C	625,000	4.00	2,500
1986	D	432,000	6.25	2,700
1986	E	478,540	10.50	4,688
1987	E	824,892	10.50	8,425
1988	F	800,000	12.50	9,341
		3,657,432		\$28,895

Each share of Series A and B Preferred Stock was converted into five shares of Common Stock, and each share of Series C, D, and 57,507 shares of Series E Preferred Stock was converted into one share of Common Stock at the closing date of the Company's initial public offering in May 1988. Each remaining share of Series E and F was converted into one share of Common Stock in June 1988, due to an automatic conversion feature in their respective Preferred Stock agreements.

NOTE 7 COMMON STOCK

In May 1988, the Company sold 1,800,000 shares of Common Stock at \$14.00 per share (net proceeds of \$22,593) in an underwritten public offering. The Company has reserved 2,832,740 shares of Common Stock for future issuance under its employee stock plans.

Employee Stock Purchase Plan

In 1981, the Company adopted the Employee Stock Purchase Plan (the Plan). The Plan was administered and terms of stock purchases were established by the Board of Directors. Under the terms of the Plan, shares were sold to certain of the Company's officers, employees and consultants at prices not less than the fair value of the common shares, as determined by the Board of Directors, at the date of purchase. Shares sold under the terms of the Plan generally vest ratably over a five year period commencing from the date of issuance. Unvested stock may not be sold or transferred and in the event a purchaser's relationship with the Company is terminated for any reason during the vesting period, the Company has the right to repurchase such unvested shares at their original issue price. This Plan was terminated on December 31, 1986. As of June 30, 1988, 35,057 shares were subject to repurchase under the terms of the Plan at prices ranging from \$.02 to \$2.50 per share.

In 1988, the Company adopted the Employee Stock Purchase Plan (the ESPP). Under the ESPP, the Company may offer shares of Common Stock to participating employees to purchase shares through payroll deductions at a price of not less than 85% of the fair market value of the Common Stock. The first offering period under this plan commenced July 1, 1988.

Nonqualified Stock Option Plan

In 1981, the Company adopted the Nonqualified Stock Option Plan (the Plan). The Plan was administered and terms of option grants were established by the Board of Directors. Under the terms of the Plan, options were granted to the Company's employees to purchase shares of Common Stock. Options generally become exercisable ratably over a five year vesting period, and expire over terms not exceeding ten years from the date of grant. The option price for all shares granted under the Plan is not less than the fair value of the Common Stock at the date of grant, as determined by the Board of Directors. The Plan terminated on December 31, 1986. As of June 30, 1988, stock options for 5,000 shares of Common Stock at an exercise price of \$2.50 per share were outstanding; no stock options were granted, exercised or cancelled during the years ended June 30, 1988 and 1987 under this Plan.

Supplemental Stock Option Plan

In 1986, the Company adopted the Supplemental Stock Option Plan (the Plan). The Plan is administered and terms of option grants are established by the Board of Directors. Under the terms of the Plan, options may be granted to certain of the Company's key employees and consultants to purchase shares of Common Stock. Options generally become exercisable ratably over a five year vesting period and expire over terms not exceeding ten years from the date of grant. The option

price for all shares granted under the Plan is not less than 85% of the fair market value of the Common Stock at the date of grant, as determined by the Board of Directors. A summary of activity under the Supplemental Stock Option Plan is set forth below:

	Shares	Exercise Price
Outstanding at June 30, 1986		
Granted	267,250	\$2.50
Exercised	(17,500)	\$2.50
Terminated	(1,900)	\$2.50
Outstanding at June 30, 1987	247,850	\$2.50
Granted	711,605	\$3.50-\$15.375
Exercised	(1,517)	\$2.50
Terminated	(14,823)	\$3.50-\$6.00
Outstanding at June 30, 1988	943,115	\$2.50-\$15.375

At June 30, 1988, options for 117,460 shares were exercisable.

Incentive Stock Option Plan

In 1984, the Company adopted the Incentive Stock Option Plan (the Plan). The Plan is administered and terms of option grants are established by the Board of Directors. Under the terms of the Plan, options may be granted to the Company's employees to purchase shares of Common Stock. Options generally become exercisable ratably over a five year vesting period and expire over terms not exceeding ten years from the date of grant. The option price for all shares granted under the Plan is equal to the fair market value of the Common Stock at the date of grant, as determined by the Board of Directors.

A summary of the activity under the Incentive Stock Option Plan is set forth below:

Shares	Exercise Price
438,282	\$.75
564,170	\$.75-\$2.50
(15,548)	\$.75
(101,445)	\$.75-\$1.50
885,459	\$.75-\$2.50
706,234	\$2.50
(69,819)	\$.75-\$2.50
(245,465)	\$.75-\$2.50
1,276,409	\$.75-\$2.50
87,638	\$2.50-\$6.00
(67,707)	\$.75-\$2.50
(103,779)	\$.75-\$3.50
1,192,561	\$.75-\$6.00
	438,282 564,170 (15,548) (101,445) 885,459 706,234 (69,819) (245,465) 1,276,409 87,638 (67,707) (103,779)

At June 30, 1988, options for 510,663 shares were exercisable.

NOTE 8 INCOME TAXES

The components of the provision for income taxes are as follows:

the compensation of the provision for meetic takes are as tollows.	For the Year Ended June 30,		
	1988	1987	1986
Current:			
U.S.	\$2,248	_	_
Foreign	1,365	\$ 292	\$ 37
State	1,322	184	37
	4,935	476	74
Deferred:			
U.S.	544	913	247
Foreign	(262)	(36)	48
State	(317)	122	173
	(35)	999	468
Provision for income taxes	\$4,900	\$1,475	\$542

Income before income taxes of the Company's foreign subsidiaries approximates operating profit as summarized in Note 10—Foreign Operations and Significant Customer

Components of the deferred tax provision which result from timing differences in the recognition of certain items for tax and financial reporting purposes are as follows:

	For the Year Ended June		ded June 30,
	1988	1987	1986
Long-term development contracts	\$ (401)	\$ 325	\$532
Deferral of support and update revenue	(1,017)	(891)	
Capitalized software development	1,569	1,076	
Depreciation	_	59	_
Unrealized exchange gains	355	-	_
Allowance for doubtful accounts	(287)	_	_
Other, net	(254)	430	(64)
Total deferred tax provision	\$ (35)	\$ 999	\$468
The second secon	===		

The provision for income taxes differs from the amount computed by applying the statutory U.S. federal income tax rate as follows:

		For the Year Ended June 30,		
	1988	1987	1986	
Tax provision at statutory rate	34.0%	46.0%	46.0%	
Income of foreign operations taxed at various rates	3.7	3.6	8.2	
State income taxes, net of federal benefits	5.4	4.0	4.7	
Investment, foreign and research tax credits	(3.5)	(15.5)	(35.3)	
Other, net		(.8)	1.0	
Effective tax rate	39.6%	37.3%	24.6%	

Financial Accounting Standard No. 96

In December 1987, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 96, "Accounting for Income Taxes." SFAS 96 mandates the liability method for computing deferred income taxes. The Company has not adopted SFAS 96 in 1988. Adoption of the new Statement is not expected to have a significant effect on the Company's financial position or results of operations.

NOTE 9 TRANSACTIONS WITH RELATED PARTIES

During the years ended June 30, 1988, 1987 and 1986, the Company paid \$117, \$108 and \$100, respectively, in consulting fees to a director and two officers of the Company who are stockholders but not salaried employees of the Company. These amounts have been expensed as research and development costs.

During the year ended June 30, 1986, the Company issued 73,800 shares of Common Stock at \$1.50 per share (the fair value at date of issuance) to the Company's chief executive officer for \$11 in cash and a \$100 note payable to the Company bearing interest at 8%. The outstanding principal and interest were paid in full during the year ended June 30, 1988.

NOTE 10 FOREIGN OPERATIONS AND SIGNIFICANT CUSTOMER

The Company operates exclusively in the computer software industry, developing and marketing computer software and providing technical support for its products. The Company sells its products through its own sales organization. Subsidiaries were charged royalties on revenues to unaffiliated customers; such royalties are eliminated in consolidation.

The Company's operations by geographic area are as follows:

	United States	Europe	Other	Consolidated
Year ended June 30, 1988:				
Revenues	\$50,902	\$30,712	\$5,772	\$87,386
Operating profit	9,100	1,493	257	10,850
Identifiable assets	70,325	27,114	3,527	100,966
Year ended June 30, 1987:				
Revenues	\$34,076	\$10,613	\$1,876	\$46,565
Operating profit (loss)	3,253	120	(271)	3,102
Identifiable assets	36,218	8,633	1,513	46,364
Year ended June 30, 1986:				
Revenues	\$22,940	\$ 4,230	\$ 968	\$28,138
Operating profit (loss)	2,884	(353)	(28)	2,503
Identifiable assets	19.961	3,576	484	24,021

Included in United States revenues are export sales to customers located primarily in Europe of \$2,136, \$3,716 and \$3,599 in fiscal years 1988, 1987 and 1986, respectively.

There were no major customers (accounting for 10% or more of sales) in 1988 or 1987. One major customer accounted for 12% of revenues during the year ended June 30, 1986.

NOTE 11 RESTATEMENT OF PRIOR YEAR FINANCIAL STATEMENTS

The Company changed its accounting policy in 1987 from straight line to accelerated depreciation for computer equipment acquired to perform specific development contracts. This accounting change results in a better matching of costs and revenues. In accordance with the initial registration of securities exemption in Accounting Principles Board Opinion No. 20, the effects of this accounting change have been reflected in the consolidated financial statements by retroactively restating all years prior to the year in which the change was adopted, which results in all years being consistently presented. The effect of this change was to increase depreciation expense for 1987 and 1986 by \$157 and \$206, respectively; and decrease net income for 1987 and 1986 by \$97 (\$.01 per share) and \$156 (\$.02 per share), respectively. Effective July 1, 1985, the Company changed on a prospective basis its method of accounting for maintenance revenues from recognizing revenue upon contract signing to recognizing such revenues ratably over the period to which they relate; the 1986 consolidated financial statements have also been adjusted to reflect this accounting change on a retroactive restatement basis.

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Stockholders of Relational Technology, Inc.

We have examined the consolidated balance sheets of Relational Technology, Inc. and its subsidiaries as of June 30, 1988 and 1987, and the related consolidated statements of income, of changes in stockholders' equity and of changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The consolidated financial statements for the year ended June 30, 1986 (prior to restatement and except for earnings per share data) were examined by other independent accountants whose opinion for the year ended June 30, 1986, dated August 22, 1986, was qualified as to the consistent application of accounting principles due to a change, with which they concurred, in the method of accounting for maintenance revenues. As described in Note 11 to Consolidated Financial Statements, the consolidated financial statements for the year ended June 30, 1986 have been restated for this change resulting in the consistent application of the accounting policy for maintenance revenues for all years presented.

In our opinion, the consolidated financial statements examined by us present fairly the financial position of Relational Technology, Inc. and its subsidiaries at June 30, 1988 and 1987, and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied during the period except for the change as of July 1, 1986, with which we concur, in the method of accounting for software development costs as described in Note 1 to Consolidated Financial Statements.

We also examined the adjustments described in Note 11 to Consolidated Financial Statements that were applied to restate the consolidated financial statements for the year ended June 30, 1986 and the computation of net income per share for that year. In our opinion, such adjustments were appropriate and have been properly applied to those financial statements, and such computation is appropriate and has been properly presented in those financial statements.

San Francisco, California

Price Waterhouse

August 10, 1988

Corporate Headquarters

1080 Marina Village Parkway Alameda, California 94501 415/769-1400

Directors and Officers

Gary J. Morgenthaler Chairman of the Board

Paul E. Newton President, Chief Executive Officer and Director

Other Directors

Robert C. Miller Chairman and Chief Executive Officer MIPS Computer Systems, Inc.

Charles G. Moore General Partner Welsh, Carson, Anderson & Stowe

Michael R. Stonebraker Professor of Electrical Engineering and Computer Sciences University of California, Berkeley

William H. Younger, Jr. General Partner Sutter Hill Ventures

Other Officers

Nicholas Birtles Vice President, International Operations

Robert Healy Vice President, Marketing

Lawrence A. Rowe Vice President, Advanced Development

William M. Smartt Vice President, Finance and Administration and Chief Financial Officer

Martin J. Sprinzen Vice President, Engineering

Michael J. Wilson Vice President, Field Sales

Thomas A. Wilson Vice President, Corporate Sales

Kimball S. Atwood General Counsel

Olivia F. Orr Controller

Eugene Wong Secretary

Relational Technology Offices

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Relational Technology Intl. Pty. Ltd. 608 St. Kilda Road, 1st Floor Melbourne, VIC, AU 3004 (613) 529-8022

Annual Meeting of Stockholders

The annual meeting will be held on November 17, 1988.

Annual Report/10-K Report

Publications of interest to current and potential Relational Technology Inc. investors are available upon written request, without charge. These include annual and quarterly reports and the Form 10-K filed with the Securities and Exchange Commission.

Requests should be made to:

Investor Relations Department Relational Technology, Inc. 1080 Marina Village Parkway Alameda, California 94501

Independent Accountants

Price Waterhouse 555 California Street San Francisco, California 94104

Outside Legal Counsel

Cooley, Godward, Castro, Huddleson & Tatum One Maritime Plaza San Francisco, California 94111

Transfer Agent and Registrar

The First National Bank of Boston Shareholder Services Division 50 Morrissey Blvd., Bldg. D-2 Dorchester, Massachusetts 02125 617/929-5445

Stock Listings

The Company's stock is traded publicly in the over-the-counter National Market on the National Association of Securities Dealers Automated Quotation System (NASDAQ) under the symbol RELY.

Stock Information

The Company's stock was quoted on the NASDAQ for the fourth quarter at a high of \$18% and low of \$14. No cash dividends have been paid in the past and none are expected in the near future. At June 30, 1988, there were 305 stockholders of record. RELATIONAL TECHNOLOGY, INC.