FORM 10-K405

Annual report pursuant to section 13 and 15(d), Regulation S-K Item 405

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FILER

MECHANICAL DYNAMICS INC \MI CIK:**1011451**| IRS No.: **382163045** | State of Incorp.:**MI** | Fiscal Year End: **1231** Type: **10-K405** | Act: **34** | File No.: **000-20679** | Film No.: **99575081** SIC: **5045** Computers & peripheral equipment & software	Mailing Address *2301 COMMONWEALTH BLVD* *ANN ARBOR MI 48105*	Business Address *2301 COMMONWEALTH BLVD* *ANN ARBOR MI 48105* *3139132509*

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended: DECEMBER 31, 1998, OR

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

For the transition period from ___________ to ___________

Commission file number: 0-20679

MECHANICAL DYNAMICS, INC.
(Exact name of registrant as specified in its charter)

<TABLE>

<S>	<C>
MICHIGAN	38-2163045
(State of incorporation)	(I.R.S. Employer Identification No.)

</TABLE>

2301 COMMONWEALTH BLVD.
ANN ARBOR, MICHIGAN 48105
(734) 994-3800
(Address of principal executive offices, including zip code, and telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:
Title of each class: NONE Name of each exchange on which registered: NONE

Securities registered pursuant to Section 12(g) of the Act:
COMMON SHARES, NO PAR VALUE
(Title of class)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. [X] Yes [ ] No

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

The aggregate market value of the voting stock of the Registrant held by non-affiliates of the Registrant as of March 3, 1999, computed by reference to the Nasdaq closing price on such date, was approximately $30,961,000.

The number of outstanding shares of the Registrant's common stock, as of March 3, 1999, was 6,237,097.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 1999 Annual Meeting of Shareholders, scheduled to be held on May 13, 1999, are incorporated by reference into Part III.

MECHANICAL DYNAMICS, INC.

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PART I

ITEM 1. BUSINESS

GENERAL

Since Mechanical Dynamics, Inc. ("MDI" or the "Company") was incorporated in Michigan in 1977, the Company has developed, marketed and supported virtual prototyping solutions. The Company's ADAMS mechanical system simulation software allows engineering teams to create virtual prototypes of their complex mechanical system designs on the computer. By realistically simulating the full-motion behavior of their designs, they can explore multiple design variations, testing and refining until optimizing system performance. In doing so, they reduce the need for costly, time-consuming physical prototype testing, while significantly improving product quality.

ADAMS makes the idea of concurrent engineering real. It enables those involved at each step of the product development process - from initial concept through design and testing - to interact with the virtual prototype, to see the whole system in motion and provide input even from the earliest stages. This not only shortens the development cycle and increases product quality, but also improves the product development process itself. Leading manufacturers from nearly every industry today use the Company's software and consulting services.

In recent years, the Company has made strategic business acquisitions to expand its ability to develop and market new products to customers. In 1994, the Company acquired five European entities that previously had distributed the Company's products in Europe and are now wholly-owned subsidiaries: Mechanical Dynamics GmbH, a German corporation; Mechanical Dynamics Sarl, a French corporation; Mechanical Dynamics International Ltd., a United Kingdom corporation; Mechanical Dynamics Sweden AB, a Swedish corporation; and Mechanical Dynamics Italy srl, an Italian corporation. In 1997, the Company established a Japanese subsidiary, Mechanical Dynamics Japan K.K., through a joint venture agreement with Information Services International-Dentsu, Ltd. ("ISI-Dentsu") of Tokyo, Japan, the distributor of the Company's software in Japan. In 1997, the Company also acquired StatDesign, Inc., a provider of engineering software and services for product design and development, primarily to Ford Motor Company.

In January 1998, the Company acquired 100% of the outstanding capital stock of DTI Asia Pte. Ltd. ("DTI"), a provider of mechanical design simulation software embedded in the AutoCAD and Mechanical Desktop product lines from

Autodesk, Inc. The aggregate purchase price of approximately $1.7 million consisted of $563,000 in cash and 142,540 shares of the Company's common stock valued at approximately $1.1 million. Subsequent to the closing of the acquisition, the operations of DTI were integrated within the Company. See Note 2 of Notes to Consolidated Financial Statements.

In August 1998, the Company established a Canadian subsidiary, Mechanical Dynamics Ltd. ("MDI-Canada"). Immediately following its formation, MDI-Canada acquired the Design Analysis Group and certain other assets of H.G.E. Inc. ("HGE"), an engineering software and services firm focusing on the aerospace industry based in Toronto, Ontario, Canada. The aggregate purchase price of approximately $2.2 million consisted principally of cash. Subsequent to the closing of the acquisition, the operations of HGE were integrated within the Company. See Note 2 of Notes to Consolidated Financial Statements.

In November 1998, the Company formed a strategic partnership with the University of Iowa in which component-level durability sensitivity analysis technology developed by the University will be integrated with the Company's ADAMS virtual prototyping software to provide system-level durability design sensitivity analysis capabilities. The Company paid $400,000 to the University for the ability to jointly develop and market this technology. See Note 2 of Notes to Consolidated Financial Statements.

ADAMS(R) and the Company's logo are registered trademarks of the Company. ADAMS/Animation, ADAMS/Car, ADAMS/Controls, ADAMS/Driver, ADAMS/Exchange, ADAMS/Flex, ADAMS/Linear, ADAMS/Pre, ADAMS/Rail, ADAMS/Solver, ADAMS/Tire, ADAMS/View, AutoDOE, CAT/ADAMS, Dynamic Designer and MECHANISM/Pro are trademarks of the Company. All rights reserved. All other trade names and trademarks appearing in this Form 10-K are the property of their respective holders.

PRODUCTS

MDI develops, markets and supports virtual prototyping software packages capable of simulating the many varied and complex component interactions and operating environments that companies face when designing their products. The Company's primary software line is the ADAMS Professional Series. The principal product in this line, the ADAMS Full Simulation Package, is comprised of ADAMS/Solver and ADAMS/View, and can be used as a self-contained software package or with additional modules developed by the Company as well as with third-party software. In addition, certain original equipment manufacturers ("OEM") license the Company's kinematic motion simulation software in order to embed the Company's software in the OEM's design software packages. The U.S. list price for the ADAMS Full Simulation Package is approximately $25,000 per license depending upon configuration. The U.S. list prices for the Company's additional software products typically range from $3,000 to $20,000. The Company also packages several of its additional software products into industry or application-specific packages. These packages have U.S. list prices ranging from $13,000 to $66,000. In the future, the Company intends to offer additional products and packages as part of its ADAMS software product line. Since the Company's sales are concentrated in this product line, a decline in the demand for ADAMS software and services would have a material adverse effect on the Company's business, financial condition and results of operations.

ADAMS and the modular packages of ADAMS software are available on a number of platforms, including Intel Pentium-based PCs running the Microsoft Windows NT operating system, UNIX-based workstations and servers from Silicon Graphics, Hewlett-Packard, Sun Microsystems, IBM and Digital Equipment.

ADAMS PROFESSIONAL SERIES

Full Simulation Package

- ADAMS/Solver is the underlying solution "engine." ADAMS/Solver automatically formulates and solves the equations of motion to provide complete kinematic, static and dynamics analysis of mechanical systems.

- ADAMS/View is an interactive graphical environment for the full ADAMS product line. ADAMS/View combines simple iconic, point-and-click operation with advanced model-building, simulation, animation and xy plotting capabilities.

Industry-specific packages

- ADAMS/Car was developed by the Company in collaboration with AB Volvo, Audi AG, BMW, Nissan Motor Co., Renault and Rover Group P.L.C. ADAMS/Car is a special version of ADAMS designed specifically for advanced vehicle simulation. Embedded within the software are the specialized design and analytical expertise of automotive industry leaders. A custom menu-driven user interface highlights capabilities familiar to vehicle designers so customers can use ADAMS/Car with little formal training.

- ADAMS/Tire is a comprehensive set of tools for simulating the complex force interactions between rubber tires and driving surfaces. This can be important input for understanding vehicle behavior under a variety of conditions.

- ADAMS/Driver allows the user to add the element of human driver response to vehicle simulations. ADAMS/Driver can simulate the actions and reactions of a vehicle's operator under a variety of driving conditions.

- ADAMS/Pre is a pre-processing environment for ADAMS designed specifically for the automotive environment.

- AutoDOE is a software package used for creating statistically defined design of experiments programs. Design of experiments methods allow users to run a battery of simulations on a mechanical system design to determine the effects of multiple design or manufacturing variations on system performance and behavior. With design of experiments, product designs can be optimized more quickly than through the traditional process of testing one factor at a time.

- ADAMS/Rail was developed by the Company in collaboration with Dutch Rail and provides virtual prototyping capabilities tailored to the needs of the worldwide railcar manufacturing industry. The software combines specialized railcar design and analytical know-how with custom menus and functions developed specifically for railcar engineers.

Visualization Option

- ADAMS/Animation allows a user to see the complete system in motion -- in real time, fully shaded and rendered. ADAMS/Animation checks and reports potential collision of parts and components and shows important measurements on screen. ADAMS/Animation also allows for multiple light sources, texture mapping, detailed color specifications and multiple perspectives. These enhance the understanding of the design and can result in more successful design reviews.

ADAMS INTERFACE PRODUCTS

Interface Products are products specifically designed for the CAD/CAM/CAE environments. Assemblies created within the Company's partners' software environments are converted into realistic, fully three-dimensional mechanical system models. These software environments then verify and evaluate motion paths, locate lock-up positions, detect interferences, establish work-space envelopes and calculate joint reaction forces.

ADAMS CAE Interface Products

- ADAMS/Flex automates the exchange of data between ADAMS and finite element analysis ("FEA") software, including ANSYS and MSC/NASTRAN. This two-way interface provides for accurate loading conditions for FEA and a more complete understanding of flexible effects on mechanical systems.

- ADAMS/Linear simplifies the non-linear equations of motion calculated by ADAMS. Having such data in linear form can significantly enhance the ability to study the stability and vibratory behavior of mechanical system models. ADAMS/Linear can also provide an easy link to popular control system design packages such as MATRIXx and MATLAB.

- ADAMS/Controls simplifies the integration of non-linear ADAMS mechanical models with control and hydraulic systems developed in leading control system design packages including MATLAB, MATRIXx and EASY5. The product allows the user to test how control systems will affect their mechanical system, and visualize the effects of both controls and mechanics in a virtual system test environment.

ADAMS CAD/CAM Interface Products

- ADAMS/Exchange provides an industry-standard, two-way interface for exchanging model geometry between ADAMS and many other CAD/CAM packages. This saves time in data transfer, while enhancing the accuracy and realism of mechanical system simulations.

- CAT/ADAMS was developed by the Company in collaboration with a consortium of major automotive manufacturers, and was designed to facilitate the exchange of data between ADAMS and the widely-used CATIA computer-aided design, manufacturing, and engineering (CAD/CAM/CAE) package from Dassault Systemes.

- Dynamic Designer was purchased by the Company in conjunction with its acquisition of DTI, in January 1998. Dynamic Designer is a mechanical design simulation software product embedded in the AutoCAD and Mechanical Desktop product lines from Autodesk, Inc. Similar embedded ADAMS simulation capabilities for SolidWorks 97 from SolidWorks Corp. have been developed by the Company.

- MECHANISM/Pro is a program specifically designed for Parametric Technology Corp.'s ("PTC") Pro/ENGINEER environment. MECHANISM/Pro converts assemblies created within PTC's Pro/ASSEMBLY software into realistic, fully three-dimensional mechanical system models. MECHANISM/Pro can verify and evaluate

motion paths, locate lock-up positions, detect interferences, establish work-space envelopes and calculate joint reaction forces.

ADAMS OEM PRODUCTS

OEM Products are kinematic motion simulation products that are embedded in OEMs' design software packages. The Company has entered into license agreements or arrangements with several OEMs, including Structural Dynamics Research Corporation ("SDRC"), Unigraphics Solutions Inc., Bentley Systems, Engineering Animation, Inc., Tecnomatix Technologies Ltd., and Applicon, under which the OEMs are licensed to embed the Company's products in the OEMs' software packages. These products provide limited virtual prototyping capabilities, and can be upgraded by licensing ADAMS/Solver directly from the Company.

SERVICES

The Company provides consulting, training and technical support services to customers in connection with a wide range of product design and engineering projects. MDI's primary objectives with regard to its services include: (1) providing total solutions to its customers' problems; (2) leveraging software sales; (3) enhancing customer loyalty and repeat and renewal business; (4) growing the services business of the Company profitably; (5) aggressively exploring and penetrating new markets; and (6) obtaining customer feedback on its products.

The Company strives to identify key companies within various industries with whom it seeks to develop close working relationships. The Company seeks to foster technological partnerships with these companies by providing a comprehensive service package, which addresses the particular virtual prototyping needs of the companies. By doing this, MDI provides a total solution for the customer, which can lead to increased acceptance of virtual prototyping in the applicable industry.

In addition to its consulting services, the Company also provides training to enable its customers to more easily integrate virtual prototyping technology into their design and quality control processes.

The Company's services staff provides these services on either a time and materials or a fixed fee basis depending on the project and the requirements of the customer. Contract fees range from a few thousand dollars to several hundred thousand dollars depending upon the scope of the project, and contract durations range from a few weeks to several years. From time to time the Company has incurred losses in connection with fixed price contracts. If the Company underestimates the expenses required to perform under fixed fee contracts, it could incur losses on these contracts. The Company has not incurred a material loss from underestimating the expenses on any fixed fee contract during 1998, 1997 or 1996.

A critical component of MDI's strategy is to provide a wide range of customer support services. These services include hotline support and on-site support and training. Product support is provided pursuant to renewable annual maintenance contracts. Customers who purchase maintenance agreements receive product enhancement releases and hotline support at no additional charge. On-site support and training are priced separately. Approximately 16.3%, 15.9%, and 16.2% of the Company's total revenue was realized from maintenance contracts in 1998, 1997, and 1996, respectively.

CUSTOMERS

The Company's customers include companies in a wide variety of industries. Historically, the Company's largest customers have been automobile manufacturers and automotive suppliers operating in an industry which can be highly cyclical. During 1998, 1997, and 1996, automotive-related customers accounted for approximately 54.7%, 50.5%, and 48.1% of the Company's total revenue, respectively. No customer accounted for greater than 10% of the Company's total revenue in 1998. Ford Motor Company accounted for approximately 10.6% and 11.8% of the Company's total revenue in 1997 and 1996, respectively. No other customer accounted for greater than 10% of the Company's total revenue in 1997 and 1996. Segments in the auto industry, in each of the United States, Europe and Japan, have, from time to time, experienced significant economic downturns characterized by decreased product demand, reductions in capital expenditures, production over-capacity, price erosion, work slowdowns, strikes and

layoffs. The Company's operations may in the future reflect substantial fluctuations from period to period as a consequence of such industry patterns, general economic conditions affecting the timing of orders from major customers and other factors affecting capital spending. There can be no assurance that such factors will not have a material adverse effect upon the Company's business, financial condition and results of operations.

SALES AND MARKETING

The Company markets its products through direct sales in North America, Europe and to a lesser extent in Asia, approximately 15 value-added resellers throughout North America, a group of international distributors in over 20 countries and through reselling alliances with certain integrated mechanical CAD/CAM/CAE software vendors. The Company conducts sales activities from its headquarters in Ann Arbor, Michigan, domestic sales offices in Atlanta, GA; Austin, TX; Chicago, IL; Cleveland, OH; Los Angeles, CA; Phoenix, AZ; San Francisco, CA; and Washington D.C., as well as its subsidiaries' offices in England, France, Germany (three offices), Italy (two offices), Sweden (2 offices), Canada (2 offices), Japan and Singapore, and its foreign branch offices in China and India. The Company employs engineers and technically proficient salespersons capable of serving the technology needs of current and prospective customers' engineering, design and manufacturing staffs.

The Company has formed strategic alliances with several leading hardware vendors, including Hewlett-Packard, Silicon Graphics and Sun Microsystems. Through these strategic alliances, the Company and the vendor participate in various projects which enhance both the visibility and acceptance of the Company's products, such as joint presentations to customers and the trade press, joint advertising and promotion, conference presentations and displays.

The Company also has alliances with vendors of complementary computer-aided engineering technology, such as ANSYS, Inc., Integrated Systems, Inc., The MacNeal-Schwendler Corporation, The Mathworks, Inc. and Structural Research & Analysis Corp. These relationships entail collaborative development to support interfaces between the software products of the Company and each partner, as well as cooperative marketing and selling activity. By working with these vendors, the Company seeks to satisfy the needs of its customers across a wide range of computer-aided engineering applications. The Company and its partners jointly participate in promotional activities, trade shows, user conferences, customer presentations and customer proposals.

The Company markets and sells third party software products through distributor agreements with certain other CAE vendors whose technologies help it provide a total solution to its customers. As of December 31, 1998 the Company distributes software products of ANSYS, Inc. in both the United Kingdom and Canada in addition to providing consulting services related to those products. Throughout Sweden, the Company distributes MATRIXx, a product of Integrated Systems, Inc. Revenue from third party software products accounted for approximately 7.1%, 2.2%, and 3.0% of the Company's total revenue in 1998, 1997 and 1996, respectively.

The Company has formed relationships with several CAD/CAM companies, including Applicon, Inc., Autodesk, Inc., Bentley Systems, Inc., Dassault Systemes, Engineering Animation, Inc., Parametric Technology Corp., SolidWorks Corp., Structural Dynamics Research Corporation, Tecnomatix Technologies Ltd., and Unigraphics Solutions Inc. Through these alliances, the Company collaborates with its partners to develop and support embedded, add-on software modules for each CAD/CAM environment. These embedded modules enable CAD/CAM users to model and simulate mechanical systems and interface with the Company's full ADAMS product line. The Company believes that strategic alliances are important to its long-term success and intends to continue to pursue such alliances in the future.

International revenue (i.e., revenue from sales outside of North America) accounted for approximately 62.4%, 65.2%, and 67.0% of the Company's total revenue in 1998, 1997, and 1996, respectively. In Asia, and, to a lesser extent, in North America and Europe, the Company markets its products and services through contractual relationships with distributors. A significant portion of the Company's revenue in Asia is derived from its distributors in Japan, Korea, India, China, Taiwan and Singapore. The Company's largest distributor, ISI-Dentsu, is located in Japan and accounted for approximately 13.2%, 15.3%, and 16.5% of the Company's total revenue in 1998, 1997, and 1996, respectively. There can be no assurance that in the future the Company's current distributors will choose or be able to market or service and support the Company's products effectively, that economic

conditions or industry demand will not adversely affect the distributors or that such distributors will not devote greater resources to marketing and supporting products of other companies. Additionally, because the Company's products are typically used by skilled professionals, in order to be effective, a distributor must possess sufficient technical, marketing and sales resources and must devote these resources to a lengthy sales cycle, customer training and product service and support. Only a limited number of distributors possess such resources. The loss of or a significant reduction in revenue from a distributor could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company's consolidated operations to date have not been materially adversely affected by the recent uncertainty in the Asian markets. During 1998, the Company experienced a decrease in revenue from Korea; however, this decrease was more than offset by revenue growth in Japan. If the economies in Asia continue to deteriorate in 1999, the Company's overall Asian revenue could be adversely impacted, which could have a material adverse effect on the Company's consolidated results of operations. A summary of the Company's revenue by geographic area is presented in Note 8 of Notes to Consolidated Financial Statements.

The Company generally prices its software products and services in local currencies in Europe, Canada and Japan. The strengthening of the dollar in 1998, relative to the European and Japanese currencies, negatively affected 1998 international revenue by approximately $883,000. Since most of the Company's international operating expenses were incurred in foreign currencies, the net impact of exchange rate fluctuations on income from operations was considerably less than the impact on revenue. If the U.S. dollar continues to strengthen in 1999 relative to the European, Canadian and Japanese currencies, the Company's international revenue will be negatively impacted, which could have a material adverse effect on the Company's consolidated results of operations.

The Company expects that international sales will continue to account for a significant portion of its total revenue in future periods. The Company intends to continue to expand its operations outside of the United States, which will require significant management attention and financial resources. International operations are subject to inherent risks, including unexpected changes in regulatory requirements, tariffs and taxes, difficulties in staffing and managing foreign operations, longer payment cycles, greater difficulty in accounts receivable collection, compliance with applicable export licensing requirements and other trade barriers and political and economic instability. Moreover, gains and losses on the conversion to U.S. dollars of receivables and payables arising from international operations may contribute to fluctuations in the Company's results of operations. As more fully described in Note 1 of Notes to Consolidated Financial Statements, the Company's risk management strategy uses derivative financial instruments in the form of forward foreign exchange contracts for the purpose of hedging foreign currency market exposures of its ongoing business operations. The Company does not enter into derivative contracts for the purpose of trading or speculative transactions. If for any reason exchange or price controls or other restrictions on foreign currencies were imposed, the Company's business, financial condition and results of operations could be materially adversely affected. Currency exchange fluctuations in countries in which the Company licenses its products in U.S.

dollars could have a material adverse effect on the Company's business, financial condition and results of operations by resulting in pricing that is not competitive with products priced in local currencies. In addition, the laws of certain countries do not protect the Company's products and intellectual property rights to the same extent as do the laws of the United States. There can be no assurance that any of these factors will not have a material adverse effect on the Company's future international operations and sales and, consequently, on the Company's business, financial condition and results of operations.

RESEARCH AND DEVELOPMENT

The Company's success depends in large part upon its ability to enhance current products and to develop and introduce new products on a timely and cost-effective basis. The Company's current software development efforts are focused on developing additional products and services to complement its core competencies of developing, marketing and supporting mechanical system modeling and simulation software packages.

The Company has historically released at least one new version of its software to its customers per year and intends to continue such releases. The Company also provides periodic releases to its OEM software partners. As part of this release process, the Company continually communicates with its customers and partners and solicits comments for improved ease of use and general customer satisfaction.

The Company's software developers work as a team with the Company's sales, marketing and consulting personnel to achieve a robust, high-quality product line.

The virtual prototyping industry is characterized by rapid technological changes, frequent new product introductions and evolving industry standards that may render existing products and services obsolete. Consequently, to maintain its competitive position, the Company must enhance its existing software products and develop and introduce new products on a timely basis. In addition, in order to maintain and broaden the market for its software products, the Company must support a variety of computer systems and graphics devices. There can be no assurance that the Company will not experience difficulties that could delay or prevent the successful development, introduction and marketing of these products, or that such new products and product enhancements will adequately meet the requirements of the marketplace and achieve market acceptance. If the Company is unable to develop and introduce products in a timely manner in response to changing market conditions or customer requirements, the Company's business, financial condition and results of operations would be materially adversely affected.

Software products as complex as those offered by the Company may contain defects or failures that may be detected at any point in the product's life cycle. The Company has, in the past, discovered software defects in certain of its products. The Company's standard warranty provides that if the software does not function to published specifications, the Company will, within a limited time period following delivery, use its best efforts to repair or replace the defective software without charge. To date, the Company has not experienced significant technical errors or other product performance issues and warranty costs have been insignificant. There can be no assurance that, despite testing by the Company, errors will not be found in current or new products after commencement of commercial shipments, resulting in injury to the Company's reputation, increased warranty and service costs, loss of market share or failure to achieve market acceptance. Any such occurrence could have a material adverse effect upon the Company's business, financial condition and results of operations.

The Company also sponsors and maintains a network of academic and commercial research affiliates to promote recognition and commercialization of applicable emerging technology. Some of the technology areas which have recently been explored include: kinematics, elastodynamics, numerical methods, design sensitivity, optimization, symbolic computing, advance graphics and visualization, user interfaces, tire dynamics, biomechanics, ergonomics, controls design and hydraulics.

As of December 31, 1998, the Company's research and development group consisted of 58 full-time employees. During 1998, 1997, and 1996, the Company's research and development expenses were approximately $5.3 million, $4.7 million, and $3.6 million, respectively. The Company anticipates that it will commit substantial resources to research and development in the future.

BACKLOG

The Company typically ships its products within 30 days after acceptance of a customer purchase order and execution of a software license agreement. Accordingly, the Company does not believe that its backlog at any particular point in time is indicative of future revenue levels.

COMPETITION

The markets for the Company's products and services are highly competitive and subject to rapid change. The Company believes the principal competitive factors in this market are product quality, ease of use, quality of support, performance and price, functionality and features, ease of integration with customers' design processes, strategic alliances and vendor and product reputation. In general, the Company's current competition comes from three sources: the traditional method of testing hardware prototypes, whether performed internally or externally, by the Company's current or potential customers, other virtual prototyping software vendors, including Parametric Technology Corp. and The MacNeal-Schwendler Corporation, and the internal software development groups of its current or potential customers. Many companies have their own software development groups that historically have developed their own software design tools. This has required the Company and other vendors to compete against these internal groups to sell their products into these companies. A number of the Company's competitors have

longer operating histories, greater financial, technical, sales, marketing and other resources, greater name recognition, more extensive distribution and sales networks and a larger, more established customer base. Among the Company's current and potential competitors are also a number of large hardware and software companies that may develop or acquire products that compete with the Company's products. Current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address the needs of the Company's prospective customers. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. Increased competition is likely to result in price reductions, reduced operating margins and loss of market share, any of which could materially adversely affect the Company's business, results of operations and financial condition. There can be no assurance that the Company will be able to compete successfully in the future or that competitive pressures will not have a material adverse effect the Company's business, financial condition and results of operations.

The Company's products address the market for virtual prototyping software. Because this market is still evolving, it is difficult to assess or predict with any assurance the growth rate, if any, and size of this market. Also, as is typical in the case of a new and evolving industry, demand and market acceptance for virtual prototyping software products and services are subject to a high level of uncertainty. The Company's future financial performance will depend in large part on growth in the virtual prototyping market and upon its ability to successfully market its ADAMS products and services. There can be no assurance the virtual prototyping market will grow in the future or that the Company's products and services will achieve wider market acceptance. There are certain prototyping applications to which the Company's products may not provide an effective solution due to limitations in the capabilities of the Company's products and, as such, the Company's products may not be accepted by certain customers. If the virtual prototyping market fails to grow or grows more slowly than anticipated, or if the Company's products do not achieve significant market acceptance, the Company's business, financial condition and results of operations will be materially adversely affected.

PROPRIETARY RIGHTS

The Company's success depends in large part upon its proprietary software technology. The Company currently relies on trade secret, copyright and trademark laws, and license agreements with all of its customers to protect its proprietary rights in its software products. The Company also ships its software with either an encoded password scheme or a security device. The Company's software copies are locked to a specific central processing unit and contain codes that will prohibit the user from running the software after a certain date. The Company generally enters into proprietary information and confidentiality agreements with its employees and distributors, and limits access to and distribution of its software, documentation and other proprietary information. The Company generally does not license or release the source code for its proprietary software to third parties. Despite these precautions, there can be no assurance that a third party will not copy or otherwise obtain and use the Company's products or technology without authorization, or develop similar or superior technology independently. The Company distributes its Dynamic Designer software products and demonstration copies of its other products in North America, Europe and Asia pursuant to "shrink-wrap" licenses. There can be no assurance that such licenses are enforceable. In addition, effective copyright and trade secret protection may be unavailable or limited in certain foreign countries. Litigation may be necessary in the future to enforce the Company's intellectual property rights, to protect the Company's trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of resources and could have a material adverse effect on the Company's business, financial condition and results of operations. Although the Company believes that its products do not infringe on the proprietary rights of third parties, and although the Company has received no communications from third parties alleging the infringement of the proprietary rights of such parties, there can be no assurance that infringement claims will not be asserted against the Company in the future or that any such claims will not require the Company to enter into costly litigation. Irrespective of the validity or the successful assertion of such claims, any such litigation could result in substantial costs and a significant diversion of management's attention and resources, and these results as well as any adverse judgment that might be rendered could have a material adverse effect on the Company's business, financial condition and results of operations. In addition, if any claims or actions are asserted against the Company, the Company may choose or be required to obtain a license under a third party's intellectual property rights. There can be no assurance that under such circumstances a license would be available upon reasonable terms or at all.

Certain technology used by the Company's products is licensed from third parties, generally on a nonexclusive basis. The Company believes there are alternative sources for each of the material components of technology licensed by the Company from third parties. However, the termination of any such licenses, the failure of the third parties to adequately maintain or update their products, including making their products year 2000 compliant, or a substantial increase in the license fee associated with such licenses could result in a delay in the Company's ability to deliver certain of its products while it seeks to implement technology offered by alternative sources and may adversely affect the Company's business, financial condition and results of operations. Any required replacement licenses could prove costly. Also, any such delay, to the extent it occurs at or near the end of a quarter, could result in a material adverse effect on the Company's quarterly results of operations. While it may be necessary or desirable in the future to obtain other licenses relating to one or more of the Company's products or relating to current or future technologies, there can be no assurance that the Company will be able to do so on reasonable terms or at all. Further, increased merger and acquisition activity in the technology industry could affect the Company's relationships with other third-party developers, and thus adversely affect the Company's results of operations.

EMPLOYEES

As of December 31, 1998, the Company had 283 employees, consisting of 104 in engineering services, 93 in sales and marketing, 58 in research and development and 28 in general and administrative capacities. Of these, 152 are located at the Company's headquarters in Ann Arbor, Michigan, 27 are located at the Company's domestic offices in Arizona, California, Georgia, Illinois, Indiana, Maryland, New Mexico, North Carolina, Ohio, Texas, Washington, and Wisconsin, 16 are located at the Company's Canadian subsidiary, 84 are located at the Company's European and Asian subsidiaries and 4 are located at the Company's foreign branch offices in China and India. None of the Company's employees is represented by a labor union or is subject to a collective bargaining agreement. The Company believes that its relations with its employees are good.

The Company's success depends in large part upon the continued service of its key technical and senior management personnel. The Company's success also depends on its continuing ability to attract and retain highly qualified technical, sales and marketing, and managerial personnel. Competition for such personnel is intense, and there can be no assurance that the Company can retain its key managerial and technical employees or that it can attract, assimilate or retain other highly qualified personnel in the future. If the Company is unable to hire the necessary technical personnel, the development of new products could be impaired. The Company's inability to attract, assimilate or retain personnel in the future on a timely basis could have a material adverse effect on the Company's business, financial condition and results of operations.

ACQUISITIONS

The Company periodically acquires or invests in businesses, software products and technologies which are complementary to the Company's business. The risks associated with such acquisitions or investments include, among others, the difficulty of assimilating the operations and personnel of the companies, the failure to realize anticipated synergies and the diversion of management's time and attention. In addition, such investments and acquisitions may involve significant transaction-related costs. There can be no assurance that the Company will be successful in overcoming such risks or that such investments and acquisitions will not have a material adverse effect upon on the Company's business, financial condition or results of operations.

Such investments and acquisitions may contribute to fluctuations in quarterly results of operations due to merger-related costs and charges associated with eliminating redundant expenses or write-offs of impaired assets recorded in connection with the acquisitions, any of which could negatively impact results of operations for a given period. In addition, acquisitions may result in the allocation of purchase price to in-process research and development. The SEC has recently raised issues regarding the methodologies used and allocation of purchase price to in-process research and development and has required some companies to adjust or restate prior periods to reduce allocations to in-process research and development, thereby increasing intangible assets and future amortization expense. While the Company believes that its purchase price allocations are appropriate, if the SEC were to require a change in any of the allocations, this would result in higher amortization expense, which could have an adverse effect upon the Company's results of operations.

POTENTIAL FLUCTUATIONS IN QUARTERLY RESULTS

The Company's quarterly operating results have in the past varied and may vary in the future depending on factors such as mix of direct and indirect sales, product mix, service mix, increased competition, size and timing of significant orders, seasonal factors and budgeting cycles of customers, product releases and pricing changes by the Company or its competitors, timing of new product announcements, market acceptance or delays in the introduction of new or enhanced versions of the Company's products and general economic conditions. A significant portion of the Company's revenue in previous quarter has been derived from sales to a limited number of customers, and the Company currently anticipates that future quarters will continue to reflect this trend. In addition, like many software companies, the Company has generally recognized a substantial portion of its revenue in the last month of each quarter, with this revenue concentrated in the last weeks of the quarter. Accordingly, the cancellation or deferral of even a small number of purchases of the Company's products could have a material adverse effect on the Company's business, results of operations and financial condition in any particular quarter. To the extent that significant sales occur earlier than expected, operating results for subsequent quarters may fail to keep pace or even decline. The Company's quarterly operating results have also fluctuated as a result of seasonality of customer buying patterns. Revenue is typically lower or constant in the first quarter of the year in relation to the previous year's last quarter due primarily to budgeting cycles of customers. The Company's third quarter revenue is also typically lower or constant in relation to the second quarter of the year due to the decreased level of sales from its European operations in the third quarter. Revenue from quarter to quarter is difficult to forecast, as minimal order backlog exists at the end of any quarter because the Company's products typically are shipped and revenue recognized promptly after receipt of the customers' orders.

The Company's expense levels are based, in part, on its expectations as to future revenue. If revenue levels are below expectations, operating results are likely to be adversely affected. In particular, net income may be disproportionately affected by a reduction in revenue because only a small portion of the Company's expenses varies with its revenue. There can be no assurance that the Company will be able to grow in future periods, that it will be able to sustain its historical rate of revenue growth or that its operations will remain profitable. As a result of the foregoing and other factors, the Company believes that period-to-period comparisons of its results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Fluctuations in operating results may also result in volatility in the price of the shares of the Company's common stock.

STOCK PRICE VOLATILITY

The trading price of the Company's common stock could be subject to wide fluctuations in response to quarterly variations in operating results, announcements of technological innovations, the introduction of new products or pricing changes by the Company or its competitors, proprietary rights or litigation, changes in earnings estimates by analysts and other events or factors. In addition, the stock market has from time to time experienced extreme price and volume fluctuations that have been unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the market price of the Company's common stock. In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has sometimes occurred against companies. There can be no assurance that such litigation will not occur in the future with respect to the Company. Such litigation could result in substantial costs and a significant diversion of management's attention and resources, and could have a material adverse effect on the Company's business, financial condition and results of operations. Any adverse determination in such litigation could also subject the Company to significant liabilities.

ITEM 2. PROPERTIES

The Company occupies approximately 39,000 square feet of space at its headquarters in Ann Arbor, Michigan. Approximately 3,200 square feet will expire in December 1999 with the remaining 35,800 square feet expiring in July 2000 (subject to the Company's right to extend the lease for one successive term of five years). The Company also leases sales offices in Michigan, Texas, California, Maryland, France, Sweden, England, Germany, Italy, Japan, Canada, China and India. The Company believes that its existing facilities are adequate for its needs for the next 12-18 months. Due to continued expansion, the Company will need to secure additional space after the expiration of its existing headquarters lease and is currently investigating its options for a new headquarters.

ITEM 3. LEGAL PROCEEDINGS

The Company is involved in various ordinary or routine litigation incidental to its business, none of which, in the opinion of management, is deemed to be material.

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

No matters were submitted to a vote of shareholders during the last quarter of the year ended December 31, 1998.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's common stock trades on The Nasdaq Stock Market under the symbol "MDII." The range of high and low sale prices for the Company's common stock on that market for each of the quarters in the last two years are as follows:

<TABLE>
<CAPTION>

	MARKET PRICES	
	HIGH	LOW
<S>	<C>	<C>
Year ended December 31, 1998:		
Fourth quarter..	$ 8.25	$ 3.75

Third quarter	11.00	6.31
Second quarter	14.00	9.63
First quarter	10.50	6.63
Year ended December 31, 1997:		
Fourth quarter	$10.00	$ 6.50
Third quarter	8.63	5.75
Second quarter	10.38	5.81
First quarter	13.75	6.25

</TABLE>

As of December 31, 1998, there were 203 shareholders of record of the Company's common stock. This may not be an accurate indication of the total shareholders of the Company as of December 31, 1998, since many nominees hold the Company's shares in street name for the beneficial owners.

The Company has never declared or paid cash dividends on its capital stock and anticipates that, for the foreseeable future, it will continue to retain any earnings for use in the operation of its business.

In January 1998, the Company acquired 100% of the outstanding capital stock of DTI Asia Pte. Ltd. In connection with this purchase, the Company issued 142,540 shares of the Company's common stock, none of which have been registered under the Securities Act of 1933. The consideration for this transaction was a cash payment of approximately $563,000 and the issuance of 142,540 shares of the Company's common stock valued for this purpose at approximately $1.1 million. These shares were issued in reliance upon the exemption from registration contained in Section 4(2) of the Securities Act of 1933.

ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The consolidated statement of income data for the years ended December 31, 1998, 1997, 1996, 1995 and 1994 and the consolidated balance sheet data as of December 31, 1998, 1997, 1996, 1995 and 1994 presented below are derived from the Company's consolidated financial statements audited by Arthur Andersen LLP.

<TABLE>
<CAPTION>

In thousands, except per share data	FOR THE YEARS ENDED DECEMBER 31, 1998	1997	1996	1995	1994
<S>	<C>	<C>	<C>	<C>	<C>
CONSOLIDATED STATEMENT OF INCOME DATA:					
Revenue	$ 36,575	$30,191	$25,383	$21,256	$ 16,267
Operating income (loss)	(556)(1)	965	2,503	1,666	635
Net income (loss)	(217)	744	2,071	1,381	450
Accretion of value of warrants	--	--	--	234	664
Net income (loss) available to common shareholders	(217)	744	2,071	1,147	(214)
Pro forma diluted net income (loss) per common share	(0.04)	0.13	0.41	0.30	(0.06)

</TABLE>

<TABLE>
<CAPTION>

In thousands	AS OF DECEMBER 31, 1998	1997	1996	1995	1994
<S>	<C>	<C>	<C>	<C>	<C>
CONSOLIDATED BALANCE SHEET DATA (3):					
Cash and cash equivalents	$ 16,843	$ 20,261	$ 20,570 (4)	$ 1,141	$ 817
Total assets	36,247	34,147	29,812	9,338	7,334
Long-term debt, less current portion	--	--	--	--	79
Redeemable common stock	--	--	167	859	1,191
Shareholders' equity (deficit)	25,600	23,970	22,185 (4)	1,334	(77)

</TABLE>

NOTES:

(1) For the year ended December 31, 1998, the Company recorded approximately $1.7 million in charges to operations for acquisition and related costs resulting primarily from the acquisitions of DTI Asia Pte. Ltd., certain assets of HGE, Inc. and technology from the University of Iowa.

(2) For the year ended December 31, 1997, the Company recorded a $1.7 million charge to operations for acquisition and related costs resulting from the acquisition of StatDesign, Inc.

(3) The Company has never declared or paid cash dividends on its capital stock and anticipates that, for the foreseeable future, it will continue to retain any earnings for use in the operation of its business.

(4) For the year ended December 31, 1996, the Company completed an initial public offering of its stock, which resulted in the issuance of 1,500,000 shares at $11.00 per share. An additional 354,750 shares were sold by the Company at $11.00 per share to cover over-allotments. The offering, including the over-allotments, raised $17.8 million in net proceeds.

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

The following discussion provides an analysis of the Company's financial condition and results of operations, and should be read in conjunction with the Company's consolidated financial statements and the notes included in Item 8 of this Form 10-K.

OVERVIEW

The Company develops, markets and supports virtual prototyping solutions. The Company's virtual prototyping software allows an engineer or designer to design a complete product by simulating, both visually and mathematically, a product in motion. The Company's principal software product, ADAMS Full Simulation Package, is used by customers to simulate mechanical systems. The Company's revenue has in the past been, and is expected to be in the future, derived primarily from its ADAMS Full Simulation Package and related software products and services.

FORWARD-LOOKING INFORMATION IS SUBJECT TO RISK AND UNCERTAINTY

Except for the historical information contained in this report, the matters herein contain "forward-looking" statements (as defined in the Private Securities Litigation Reform Act of 1995) that involve risk and uncertainty. These forward-looking statements include, but are not limited to, revenue levels, including the level of international revenue, certain costs and operating expense levels, the level of other income, the Company's liquidity and capital needs and various business environment and trend information. Actual future results and trends may differ materially depending on a variety of factors, including the volume and timing of orders received during the quarter; the mix of and changes in distribution channels through which the Company's products are sold; the timing and acceptance of new products and product enhancements by the Company or its competitors; changes in pricing; the level of the Company's sales of third-party products; purchasing patterns of distributors and customers; competitive conditions in the industry; business cycles affecting the markets in which the Company's products are sold; extraordinary events, such as litigation; risks inherent in seeking and consummating acquisitions, including the diversion of management attention to the assimilation of the operations and personnel of the acquired business; fluctuations in foreign exchange rates; the impact of undetected errors or defects, including those associated with Year 2000 date functions, on the Company's current products, vendors and internal systems; and economic conditions generally or in various geographic areas. All of the foregoing factors are difficult to forecast. The future operating results of the Company may fluctuate as a result of these and other risk factors detailed from time to time in the Company's Securities and Exchange Commission reports and included in Item 1 of this Form 10-K entitled "Business."

Due to all of the foregoing factors, the Company believes that period-to-period comparisons of its results of operations are not necessarily meaningful and should not be relied upon as an indication of future performance. It is likely that, in some future quarters, the Company's operating results will be below the expectations of stock market analysts and investors. In such an event, the price of the Company's common stock would likely be materially adversely affected.

RESULTS OF OPERATIONS

REVENUE
<TABLE>
<CAPTION>

In thousands	1998	% CHANGE	1997	% CHANGE	1996
<S>	<C>	<C>	<C>	<C>	<C>
Software licenses	$19,659	13.9%	$17,258	18.3%	$14,590
% of total revenue	53.7%		57.2%		57.5%
Services	$16,916	30.8%	$12,933	19.8%	$10,793
% of total revenue	46.3%		42.8%		42.5%
Total revenue	$36,575	21.1%	$30,191	18.9%	$25,383

</TABLE>

In August 1998, the Company acquired the Design Analysis Group and certain other assets of H.G.E. Inc. ("HGE"), an engineering software and services firm based in Toronto, Ontario, Canada. Revenue from the Design Analysis Group has been in the past, and is expected to be in the future, derived primarily from sales of third-party software products, professional services and sales of the Company's software products. The operating results of the Design Analysis Group have been included in the Company's consolidated results of operations from the date of acquisition.

The Company's total revenue increased 21.1% to $36.6 million in 1998 from $30.2 million in 1997. During 1997, total revenue increased 18.9% from $25.4 million in 1996. The growth in revenue during 1998 resulted primarily from an increase in services provided to the Company's customers, as well as an increase in sales of third-party products. The growth in revenue during 1997 resulted from increased sales of the Company's ADAMS Full Simulation Package, as well as other related software products and services. During both years, the Company achieved revenue growth in each of its major sales geographies, including North America, Europe and Asia. A summary of the Company's revenue by geographic area is presented in Note 8 of Notes to Consolidated Financial Statements.

Revenue from international customers accounted for approximately 62.4%, 65.2% and 67.0% of the Company's total revenue in 1998, 1997 and 1996, respectively. The decrease in international revenue as a percent of total revenue during 1998, as compared to 1997, was due primarily to weakness experienced in certain countries in Asia, as well as an increase in revenue from North America, due in part to the Company's August 1998 acquisition of HGE. The revenue shortfall experienced by the Company in Asia during 1998 resulted primarily from continuing economic pressures facing Japan and Korea, as well as the strengthening of the dollar relative to the Japanese yen, as described below. The decrease in international revenue as a percent of total revenue during 1997, as compared to 1996, was due in part to the strengthening of the dollar during 1997, as well as increased sales of the Company's software products and services in North America. If the economies in Asia continue to deteriorate in 1999, the Company's overall Asian revenue could be adversely impacted, which could have a material adverse effect on the Company's consolidated results of operations. Consequently, the Company remains cautious in its overall outlook for Asian revenue in 1999. The Company expects that international revenue will continue to account for a significant portion of its total revenue in future periods.

Outside of North America and Europe, the Company relies primarily on distributors and sales representatives for the licensing and support of its products. Distributors and sales representatives accounted for approximately 21.3%, 27.8% and 27.6% of the Company's total revenue in 1998, 1997 and 1996, respectively. The decrease in revenue from distributors and sales representatives in 1998, as compared to 1997, resulted primarily from increased revenue from professional services provided directly to the Company's customers as well as revenue generated from sales of third-party software products. The Company's Japanese distributor, Information Services International-Dentsu, Ltd. ("ISI-Dentsu"), accounted for approximately 13.2%, 15.3% and 16.5% of the Company's total revenue in 1998, 1997 and 1996, respectively.

The Company generally prices its software products and services in local currencies in Europe, Canada and Japan. The strengthening of the dollar in

1998, relative to the European and Japanese currencies, negatively affected 1998 international revenue by approximately $883,000, including $550,000 from the Japanese yen. Since most of the Company's international operating expenses were incurred in foreign currencies, the net impact of exchange rate fluctuations on income from operations was considerably less than the impact on revenue. If the U.S. dollar continues to strengthen in 1999 relative to the European, Canadian and Japanese currencies, the Company's international revenue will be negatively impacted, which could have a material adverse effect on the Company's consolidated results of operations. The strengthening of the dollar in 1997, relative to the European and Japanese currencies, negatively affected 1997 international revenue by approximately $1.2 million.

Revenue from automotive-related customers accounted for approximately 54.7%, 50.5% and 48.1% of the Company's total revenue in 1998, 1997 and 1996, respectively. No customer accounted for greater than 10% of the Company's total revenue in 1998. Sales to Ford Motor Company accounted for approximately 10.6% and 11.8% of the Company's total revenue in 1997 and 1996, respectively. No other customer accounted for greater than 10% of the Company's total revenue in 1997 and 1996.

Software licenses revenue consists primarily of license fees for the Company's software products and, to a lesser extent, license fees from third party software products licensed through the Company's European and Canadian subsidiaries. Software licenses revenue grew 13.9% over 1997 to approximately $19.7 million in 1998. The increase resulted from a higher volume of software licenses sold worldwide, primarily from third party products. In 1997, software licenses revenue grew 18.3% over 1996 to approximately $17.3 million. Revenue from third-party products accounted for $2.6 million in revenue in 1998, or 7.1% of total revenue, compared to $678,000, or 2.2% of total revenue, in 1997.

Services revenue consists primarily of revenue from software maintenance agreements and professional services, including consulting, training and funded research and development. Total services revenue grew 30.8% over 1997 to approximately $16.9 million in 1998. The overall increase in services revenue reflects the Company's continued emphasis on providing total solutions to its customers. Software maintenance revenue grew 23.8% in 1998 to $5.9 million, while professional services revenue grew 37.8% in 1998 to $10.9 million. Total services revenue grew 19.8% over 1996 to approximately $12.9 million in 1997. Both the software maintenance and the professional service components of services revenue experienced solid growth in 1997. Software maintenance revenue totaled $4.8 million in 1997, a 16.9% increase over 1996. Professional services revenue totaled $7.9 million in 1997, a 23.3% increase over 1996.

COST OF REVENUE

<TABLE>
<CAPTION>

In thousands	1998	% CHANGE	1997	% CHANGE	1996
<S>	<C>	<C>	<C>	<C>	<C>
Cost of software licenses...........	$ 2,479	213.4%	$ 791	30.5%	$ 606
Gross profit margin on software licenses revenue................	87.4%		95.4%		95.8%
Cost of services....................	$ 9,581	35.6%	$ 7,066	14.3%	$ 6,183
Gross profit margin on services revenue.........................	43.4%		45.4%		42.7%

</TABLE>

Cost of software licenses includes software royalty fees, media costs, payroll and other costs attributable to software documentation and distribution, and an allocation of depreciation, utilities and other overhead expenses incurred by the Company. Cost of software licenses revenue increased 213.4% from 1997 to approximately $2.5 million in 1998. The increase was primarily due to additional royalties paid to third parties whose products are licensed through the Company's European and Canadian subsidiaries, and, to a lesser extent, additional royalties paid to third parties whose products are embedded in the Company's ADAMS software. In 1997, cost of software licenses revenue increased 30.5% from 1996 to approximately $791,000. The $185,000 absolute dollar increase was primarily due to additional royalties paid to third parties whose products are embedded in the Company's ADAMS software.

Gross profit margin on software licenses revenue was 87.4%, 95.4% and 95.8% during the years ended December 31, 1998, 1997 and 1996, respectively. The decline in gross profit margin during 1998, as compared to 1997, was due to the increased sales of third party software products compared to sales of the Company's software products.

Cost of services includes payroll and overhead expenses attributable to hotline support, consulting, training and funded research and development. Cost of services revenue grew 35.6% over 1997 to approximately $9.6 million in 1998. In 1997, cost of services revenue grew 14.3% over 1996 to approximately $7.1 million. The increases resulted from the hiring of additional employees to support the growth in services provided to the Company's customers during 1998 and 1997.

Gross profit margin on services revenue was 43.4%, 45.4% and 42.7% during the years ended December 31, 1998, 1997 and 1996, respectively. The decline in gross profit margin during 1998, as compared to 1997, was primarily due to the increased professional services revenue as a percentage of total services revenue. Historically, professional services revenue has generated lower profit margins than revenue from software maintenance agreements.

OPERATING EXPENSES

<TABLE>
<CAPTION>

In thousands	1998	% CHANGE	1997	% CHANGE	1996
<S>	<C>	<C>	<C>	<C>	<C>
Sales and marketing.................	$ 14,245	22.3%	$ 11,644	21.1%	$ 9,612
% of total revenue................	38.9%		38.6%		37.9%
Research and development............	$ 5,265	11.3%	$ 4,729	29.7%	$ 3,647
% of total revenue................	14.4%		15.7%		14.4%
General and administrative..........	$ 3,472	8.4%	$ 3,202	17.0%	$ 2,736
% of total revenue................	9.5%		10.6%		10.8%
Goodwill amortization...............	$ 341	227.9%	$ 104	8.3%	$ 96
% of total revenue................	0.9%		0.3%		--
Acquisition-related costs and non-recurring charges............	$ 1,748	3.4%	$ 1,690	--	$ --
% of total revenue................	4.8%		5.6%		--

</TABLE>

Sales and marketing expenses include costs associated with the Company's sales channels, such as personnel, commissions, sales office costs, travel, promotional events, sales order processing, including license administration and order fulfillment, and advertising and public relations programs. Sales and marketing expenses also include an allocation of overhead expenses incurred by the Company. The absolute dollar increases in sales and marketing expenses in 1998 and 1997 resulted from the Company's continued expansion of its worldwide sales and marketing organization, as well as the increase in commissions paid on the higher level of revenue. During 1998, the number of employees in sales and marketing increased from 75 to 93. The Company expects to continue to expand its sales organization in the future to meet the growing demand for its products and services.

Research and development expenses include all payroll costs attributable to research and development activities. Research and development expenses also include an allocation of overhead expenses incurred by the Company. The absolute dollar increases in research and development expenses in 1998 and 1997 primarily resulted from an increase in personnel and related costs in support of expanded product development efforts. Funded research and development expenses, which are not included in research and development expenses but are included in cost of services revenue, were 0.7%, 2.7% and 3.6%, of total revenue in 1998, 1997 and 1996, respectively. The majority of the revenue received and expenses incurred for funded research and development was directly related to projects associated with the ongoing development of the Company's content-rich software products, including ADAMS/Car and ADAMS/Rail. The Company intends to continue to invest significant resources in research and development in the future.

General and administrative expenses include the cost of salaries, employee benefits and other payroll costs associated with the Company's finance, accounting, human resources, information systems and executive management functions. General and administrative expenses also include an allocation of overhead expenses incurred by the Company. General and administrative expenses grew 8.4% over 1997 to approximately $3.5 million in 1998, in support of the Company's growing operations worldwide. General and administrative expenses grew 17.0% over 1996 to approximately $3.2 million in 1997. The Company expects general and administrative expenses to increase in absolute dollars in the future. However, these expenses may vary as a percentage of total revenue from period to period.

Goodwill amortization includes the amortization of purchase price in excess of net assets on the Company's acquisitions. Goodwill amortization increased 227.9% in 1998, as compared to 1997, due to increased goodwill associated with the Company's 1998 and 1997 acquisitions. The Company amortizes goodwill over the periods estimated to be benefited from the acquisitions, after considering such factors as demand, competition, service lives of employees and expected actions of competitors. Goodwill amortization increased 8.3% in 1997, as compared to 1996, due to increased goodwill associated with the acquisition of StatDesign, Inc. ("StatDesign") in October 1997.

Acquisition-related costs and non-recurring charges were approximately $1.7 million in each of the years ending December 31, 1998 and 1997, and consist primarily of the write-off of purchased in-process research and development ("R&D") associated with the Company's acquisitions in these years. In each acquisition, the value assigned to purchased in-process R&D was determined by an independent appraisal of the acquired company's assets, both tangible and intangible. The portion of the aggregate purchase price assigned to in-process R&D was determined by identifying research projects for which technological feasibility had not yet been established. The appraisals considered such factors as the estimated percent complete of each project in process at the date of acquisition, the estimated remaining costs to develop the in-process R&D into commercially viable products and the estimated discounted net future cash flows from such products. If the Company were unable to complete the R&D projects in a timely manner or lost key personnel from the acquired companies, revenue and operating income in future periods could be adversely impacted. These acquisitions are discussed below and the related accounting treatment is summarized in Note 2 of Notes to Consolidated Financial Statements.

In November 1998, the Company acquired certain technology from the University of Iowa and recorded a non-recurring charge to operations of $400,000 for the write-off of purchased in-process R&D. The purchase price was allocated to in-process R&D as the software had not reached technological feasibility and no other tangible or intangible assets were identified. The technology acquired consisted of component-level durability sensitivity analysis technology. Significant projects in process at the date of acquisition included further development of this technology and integration with the Company's ADAMS software to provide system-level durability design sensitivity prediction capabilities. Since the acquisition, the Company, along with scientists from the University of Iowa, have developed a plan to jointly enhance and integrate the University's technology with that of the Company's such that a commercial product is expected to be available for release in the second half of the year 2000. Costs associated with the completion of these projects have, thus far, been consistent with the Company's expectations as of the acquisition date.

In August 1998, the Company acquired certain assets of HGE and recorded a non-recurring charge to operations of $203,000 for the write-off of purchased in-process R&D. The technology consisted of a metal stamping analysis program that simulates strain in thin metal sheets. Significant projects in process at the date of acquisition included the incorporation of springback functionality into the acquired company's technology. Springback is a term used to describe how a material's elasticity relaxes after it has been bent. The value of the in-process R&D was appraised using the income approach, and involved the following assumptions: the net cash inflows from the in-process R&D commencing in the second half of the year 2000, operating expenses consistent with historical levels and a risk-adjusted discount rate of 32.5%. Incorporation of the springback technology is in the development stages. Costs associated with the completion of the project are expected to be consistent with the assumptions used in the valuation.

In January 1998, the Company acquired DTI Asia Pte. Ltd. ("DTI") and recorded a non-recurring charge to operations of $980,000 for the write-off of purchased in-process R&D. DTI was a start-up company, established in 1994, and consisted of four employees located on three continents whose time was primarily dedicated to developing motion simulation technology for the mid-range CAD market. Significant projects in process at the date of acquisition included: (1) integrating the Company's ADAMS solution engine with the acquired company's existing technology; (2) developing advanced "wizards" to increase ease of use;

and (3) adding finite element analysis capabilities. The value of the in-process R&D was appraised using the milestone approach, and involved the following assumptions: the net cash inflows from the in-process R&D commencing in the fourth quarter of 1998, operating expenses consistent with historical levels and a risk-adjusted discount rate of 35.0%. Since the acquisition, the Company has completed integration of the ADAMS solution engine and released a new version of the acquired company's product line featuring increased ease of use. Costs associated with the completion of these projects were consistent with the assumptions used in the valuation.

In October 1997, the Company acquired StatDesign and recorded a non-recurring charge to operations of $1.7 million for the write-off of purchased in-process R&D. Established in 1992, StatDesign provided design of experiments ("DOE") technology, custom graphical user interfaces, and consulting services for product design and development. DOE methods allow users to run a battery of simulations on a mechanical system design to determine the effects of multiple design or manufacturing variations on system performance and behavior. Significant projects

in process at the date of acquisition included improvements to simulation, enhancement of modeling technology, added suspension capability, added powertrain capability, enhanced graphics and user interface and the modulization of post-processing functions. Completion of these projects has involved significantly enhancing, or, in some cases, reconstructing the internal architecture of the existing technology to achieve the desired performance guidelines and generalizing the technology to appeal to a broader customer base. The value of the in-process R&D was appraised using the income approach, and involved the following assumptions: the net cash inflows from the in-process R&D commencing in the second half of 1998, operating expenses consistent with historical levels and a risk-adjusted discount rate of 32.5%. Since the acquisition, the Company has successfully broadened the former user base of StatDesign's technology through significant progress on the projects listed above. Costs associated with the completion of these projects were consistent with the assumptions used in the valuation.

OTHER INCOME, NET

<TABLE>
<CAPTION>

In thousands	1998	% CHANGE	1997	% CHANGE	1996
<S>	<C>	<C>	<C>	<C>	<C>
Other income, net.....................	$ 828	4.7%	$ 791	47.6%	$ 536
% of total revenue..................	2.3%		2.6%		2.1%

</TABLE>

Other income, net consists of net interest income (expense), foreign currency transaction gain (loss) and gain (loss) on the disposal of property and equipment. Net interest income was $828,000, $953,000, and $556,000 in 1998, 1997 and 1996, respectively. The decline in interest income in 1998, compared to 1997, was due to lower cash and cash equivalents balances primarily as a result of cash paid for the Company's 1998 and 1997 acquisitions. Interest income increased significantly in 1997, primarily as a result of twelve months of interest earned on the $17.8 million in net proceeds raised from the Company's initial public offering in May 1996. Foreign currency transaction gain (loss) amounted to $64,000, ($129,000) and ($31,000) in 1998, 1997 and 1996, respectively. Gain (loss) on the disposal of property and equipment was ($64,000), ($33,000) and $11,000 in 1998, 1997 and 1996, respectively.

PROVISION FOR INCOME TAXES

The Company's effective income tax rates were 176.1%, 57.9% and 31.9% for 1998, 1997 and 1996, respectively. The differences between the consolidated tax provision and the income tax provision calculated at the United States federal statutory rate are summarized in Note 4 of Notes to Consolidated Financial Statements. In 1998 and 1997, the difference between the effective and statutory federal rate was primarily due to the non-deductibility of the expense associated with purchased in-process research and development on certain acquisitions. These unfavorable differences were partially offset by the benefit of the Company's foreign sales corporation, and the benefit of tax-exempt interest income. Excluding the acquisition-related charges, the Company's effective tax rate for 1998 and 1997 would have been 29.6% and 29.5%.

MINORITY INTEREST IN NET INCOME (LOSS) OF SUBSIDIARIES

In April 1997, the Company established a Japanese subsidiary, Mechanical Dynamics Japan K.K. ("MDI-Japan"), through a joint venture agreement with ISI-Dentsu of Tokyo, Japan, the distributor of the Company's software in Japan. Minority interest in net income (loss) of subsidiaries of $10,000 in 1998 and ($5,000) in 1997 represents ISI-Dentsu's 34% interest in the net income (loss) of MDI-Japan.

EMPLOYEES

The number of the Company's worldwide employees increased 20.9% to 283 at December 31, 1998, compared with 234 at December 31, 1997. Reflected in this increase are new employees who joined the Company as a result of the Company's acquisitions of DTI and HGE in 1998. Absent the impact of the acquisitions, employment increased to support the Company's growing operations worldwide.

YEAR 2000 COMPLIANCE

The Year 2000 issue is the result of computer programs using a two-digit format, as opposed to four digits, to indicate the year. Such computer systems will be unable to interpret dates beyond the year 1999, which could cause

a system failure or other computer errors. The Company has assessed and identified risks in four areas of its business and has developed a plan for Year 2000 information systems compliance in each. The areas are: (1) the Company's products, including third party software embedded in the Company's products, (2) business management and accounting systems, (3) computing and communications infrastructure, and (4) the Company's suppliers.

Since the Company's products perform few date processing tasks, there is not a significant risk of a material disruption as a result of the Year 2000. The Company has completed testing on current versions of the Company's primary products, including the software delivery and license systems of the products. No areas of non-compliance were noted which required modification to the Company's software. The Company's product development group is currently adding Year 2000 readiness to its quality assurance process for all products to ensure no Year 2000 problems are introduced during the development of software and maintenance activities. The Company's primary business management and accounting systems were replaced by the Company effective January 1999. The cost of the new systems, including certain hardware upgrades, was approximately $150,000. These systems are based on third-party products that have been certified for Year 2000 compliance. The Company's computing and communications infrastructure is currently being reviewed. An inventory of all infrastructure components has been established. All critical components of the infrastructure will be migrated to Year 2000 readiness by the third quarter of 1999. A list of key suppliers to the Company has been developed. Key suppliers have been contacted and are being asked to show adequate readiness or alternate vendors will be identified.

The Company does not expect that the costs to address its Year 2000 needs will be material to its consolidated financial position or results of operations. While the Company believes that its efforts to address Year 2000 issues for which it is responsible should be successful, it is possible that there will be undetected errors or defects associated with Year 2000 date functions in the Company's products and internal systems or those of its key suppliers. If this should occur, it is possible that the Company could be involved in litigation. Further, although the Company does not believe that it has any obligation to continue to support prior versions of its products after the termination of maintenance contracts covering those products, nor any obligation to make prior versions of its products, including custom applications written by the Company, Year 2000 compliant, it is possible that its customers may take a contrary position and initiate litigation. Because of the unprecedented nature of litigation in this area, it is uncertain how the Company may be affected by it. In the event of such litigation or the occurrence of one or more problems associated with Year 2000 compliance, the Company's business, financial condition, or results of operations could be materially adversely affected.

EURO CONVERSION

In January 1999, 11 of the 15 member countries of the European Union established fixed conversion rates between their existing sovereign currencies and the Euro, making the Euro their common legal currency on that date. There will be a transition period from January 1, 1999 to January 1, 2002, during which the old currencies will remain legal tender in the participating countries as denominations of the Euro. During the transition period, public and private parties may pay for goods and services using either the Euro or the participating country's former currency. Conversion rates, however, will no longer be computed directly from one former currency to another.

The Company is currently evaluating the business implications of conversion to the Euro, including technical adaptation of information technology and other systems to accommodate Euro-denominated transactions, long-term competitive implications of the conversion, and the effect on market risk with respect to financial instruments. At this time, the Company does not expect that the Euro's introduction will have a material impact on its results of operations during or after the transition period.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents were $16.8 million at December 31, 1998, compared to $20.3 million at December 31, 1997. The decrease in cash and cash equivalents of $3.4 million was primarily due to the $2.3 million in cash used for capital expenditures; $2.0 million in cash used in the acquisition of HGE in August 1998; $563,000 in cash used in the acquisition of DTI; and $400,000 in cash used to purchase certain technology from the University of Iowa. These decreases were partially offset by the $921,000 in cash generated from operations in 1998 and $402,000 in proceeds from stock issued by the Company during 1998.

At December 31, 1998, the Company's principal commitments consisted of obligations under operating leases for facilities and equipment, including approximately $1.7 million in payments due under noncancelable operating leases during 1999. The Company had no borrowings under long-term debt arrangements at December 31, 1998.

In November 1998, the Board of Directors authorized management of the Company to repurchase up to 500,000 shares of the Company's common stock. No shares have been repurchased to date.

In December 1998, the Company entered into an agreement with its principal bank for an unsecured $4.0 million line of credit. No borrowings were outstanding under this agreement as of December 31, 1998. The Company's subsidiaries in Italy, Sweden, and France also have line of credit and overdraft facilities that provide for aggregate borrowing availability of approximately $260,000. Approximately $105,000 in borrowings were outstanding under these facilities as of December 31, 1998.

In November 1998, the Company formed a strategic partnership with the University of Iowa in which component-level durability sensitivity analysis technology developed by the University will be integrated with the Company's ADAMS virtual prototyping software to provide system-level durability design sensitivity analysis capabilities. The Company paid $400,000 to the University for an exclusive perpetual license to jointly develop and market this technology. See Note 2 of Notes to Consolidated Financial Statements.

In August 1998, the Company acquired the Design Analysis Group and certain other assets of HGE, an engineering software and services firm focusing on the aerospace industry. The aggregate purchase price of approximately $2.2 million consisted principally of cash. See Note 2 of Notes to Consolidated Financial Statements.

In January 1998, the Company acquired 100% of the outstanding capital stock of DTI, a provider of mechanical design simulation software embedded in the AutoCAD and Mechanical Desktop product lines from Autodesk, Inc. The aggregate purchase price of approximately $1.7 million consisted of $563,000 in cash and 142,540 shares of the Company's common stock valued at approximately $1.1 million. See Note 2 of Notes to Consolidated Financial Statements.

Long-term cash requirements, other than for normal operating expenses, are anticipated for the development of new software products and enhancements of existing products, financing growth, repurchases of the Company's common stock and the possible acquisition of software products, technologies and businesses complementary to the Company's business. The Company believes that cash flows from operations, together with existing cash balances, and available borrowings will be adequate to meet the Company's cash requirements for working capital, capital expenditures and stock repurchases for the next twelve months and the foreseeable future. The Company has not paid dividends during the period 1996 through 1998 and intends to continue its policy of retaining earnings to finance future growth.

NEW ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"). SFAS 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and hedging activities. It requires that an entity record all derivatives as either assets or liabilities at fair value. Under certain conditions, a derivative may be designated as a hedge of (1) potential changes in the fair value of an asset or liability or firm commitment, (2) the foreign currency exposure of a forecasted transaction, or (3) the foreign currency exposure of the net investment in a foreign operation. The accounting for changes in the fair value of a derivative instrument depends on the intended use of the derivative and the resulting designation. The statement is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. The Company's derivative activities are currently limited to entering into forward contracts to hedge potential changes in the fair value of its receivables denominated in certain foreign currencies.

ITEM 7a. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to market risk from changes in foreign exchange and interest rates. To reduce the risk from changes in foreign exchange rates, the Company selectively uses financial instruments. The Company does not hold or issue financial instruments for trading purposes.

FOREIGN CURRENCY

The Company, at various times, enters into forward exchange contracts to hedge certain exposures related to identifiable foreign currency transactions that are relatively certain as to both timing and amount. The Company does not use any other types of derivative financial instruments to hedge such exposures, nor does it use derivatives for speculative purposes. In general, the Company uses forward exchange contracts to hedge against large, selective transactions that present the most exposure to exchange rate fluctuations. At December 31, 1998, the Company had forward foreign currency exchange contracts of $1.2 million (notional amounts). The contracts outstanding at December 31, 1998 mature through June 7, 1999 and are intended to hedge various foreign currency commitments due from foreign subsidiaries and the Company's distributors. Due to the short-term nature of these financial instruments, the fair value of these contracts is not materially different than their notional amount at December 31, 1998. The Company did not engage in hedging activities prior to 1998.

Gains and losses on the forward contracts are largely offset by gains and losses on the underlying exposures. The Company conducts business in approximately seven foreign currencies, predominantly Japanese yen, German marks and British pounds. A hypothetical 10% appreciation of the U.S. dollar from December 31, 1998 market rates would increase the unrealized value of the Company's existing forward contracts at December 31, 1998 by $105,000. Conversely, a hypothetical 10% depreciation of the U.S. dollar from December 31, 1998 market rates would decrease the unrealized value of the Company's forward contracts by $129,000. In either scenario, the gains and losses on the forward contracts are largely offset by the gains or losses on the underlying transactions.

INTEREST RATES

The Company maintains its cash and cash equivalents in highly liquid investments with maturities of 90 days or less. The Company has the ability to hold its fixed income investments to maturity, and therefore would not expect its operating results or cash flows to be affected to any significant degree by the effect of a hypothetical 10% change in market interest rates on its cash and cash equivalents.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Board of Directors and Shareholders of Mechanical Dynamics, Inc.:

We have audited the accompanying consolidated balance sheets of MECHANICAL DYNAMICS, INC. (a Michigan corporation) and subsidiaries as of December 31, 1998 and 1997, and the related consolidated statements of income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Mechanical Dynamics, Inc. and its subsidiaries as of December 31, 1998 and 1997, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1998 in conformity with generally accepted accounting principles.

/s/ ARTHUR ANDERSEN LLP

Detroit, Michigan,
January 29, 1999

MECHANICAL DYNAMICS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 1998 AND 1997

<TABLE>
<CAPTION>

In thousands, except share data	1998	1997
<S>	<C>	<C>
ASSETS		
Current assets:		
Cash and cash equivalents	$ 16,843	$ 20,261
Accounts receivable, net of allowance for doubtful accounts of $261 and $235	9,893	8,000
Prepaid and deferred expenses	1,873	1,206
Total current assets	28,609	29,467
Property and equipment, net of accumulated depreciation of $3,551 and $2,314	3,674	2,887
Goodwill, net of accumulated amortization of $695 and $354	3,820	1,498
Other assets	144	295
	$ 36,247	$ 34,147
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Borrowings under line of credit	$ 105	$ 45
Accounts payable	1,781	1,474
Accrued compensation	1,579	1,461
Other accrued expenses	1,965	2,273
Deferred revenue	4,745	4,462
Total current liabilities	10,175	9,715
Minority interest	472	462
Shareholders' equity:		
Common stock, no par value, 15,000,000 shares authorized, 6,225,206 and 5,984,061 shares issued and outstanding in 1998 and 1997, respectively	22,332	20,838
Preferred stock, no par value, 1,000,000 shares authorized, 0 shares issued and outstanding	--	--
Retained earnings	3,073	3,290
Cumulative translation adjustment	195	(158)

Total shareholders' equity	25,600	23,970
	$ 36,247	$ 34,147

</TABLE>

The accompanying notes are an integral part of these consolidated statements.

MECHANICAL DYNAMICS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME
FOR THE YEARS ENDED DECEMBER 31, 1998, 1997 AND 1996

<TABLE>
<CAPTION>

In thousands, except share and per share data	1998	1997	1996
Revenue:			
Software licenses	$ 19,659	$ 17,258	$ 14,590
Services	16,916	12,933	10,793
Total revenue	36,575	30,191	25,383
Cost of revenue:			
Software licenses	2,479	791	606
Services	9,581	7,066	6,183
Total cost of revenue	12,060	7,857	6,789
Gross profit	24,515	22,334	18,594
Operating expenses:			
Sales and marketing	14,245	11,644	9,612
Research and development	5,265	4,729	3,647
General and administrative	3,472	3,202	2,736
Goodwill amortization	341	104	96
Acquisition-related costs and non-recurring charges	1,748	1,690	--
Total operating expenses	25,071	21,369	16,091
Operating income (loss)	(556)	965	2,503
Other income, net	828	791	536
Income before income taxes and minority interest	272	1,756	3,039
Provision for income taxes	479	1,017	968
Income (loss) before minority interest	(207)	739	2,071
Minority interest in net income (loss) of subsidiaries	10	(5)	--
Net income (loss)	$ (217)	$ 744	$ 2,071
Basic net income (loss) per common share	$ (0.04)	$ 0.13	$ 0.42
Weighted average common shares	6,186,469	5,805,936	4,990,215
Diluted net income (loss) per common share	$ (0.04)	$ 0.13	$ 0.41
Weighted average common and common equivalent shares	6,186,469	5,867,753	5,070,028

</TABLE>

The accompanying notes are an integral part of these consolidated statements.

MECHANICAL DYNAMICS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 1998, 1997 AND 1996

<TABLE>
<CAPTION>

In thousands, except share data	COMMON STOCK	CONVERTIBLE PREFERRED STOCK	CLASS A & B COMMON STOCK AND WARRANTS	ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS
<S>	<C>	<C>	<C>	<C>	<C>
Balance at December 31, 1995............	$ --	$ 265	$ 458	$ 114	$ 475
Net income............................	--	--	--	--	2,071
Foreign currency translation adjustment	--	--	--	--	--
Issuance of 11,250 shares of Class B common stock.........................	--	--	--	3	--
Exercise of Class A common stock warrants and issuance of 81,060 shares of Class A common stock..............	--	--	(449)	509	--
Conversion of 354,932 shares of Convertible preferred stock into 484,758 shares of Class A common stock	--	(265)	2	263	--
Conversion of 1,178,865 shares of Class B common stock and 2,700,772 shares of Class A common stock into 3,879,637 shares of no par common stock.........	900	--	(11)	(889)	--
Termination of redemption privileges for 86,486 shares of redeemable common stock	692	--	--	--	--
Issuance of 1,880,798 shares of common stock...............................	17,991	--	--	--	--
Collections on subscriptions receivable	--	--	--	--	--
Comprehensive income....................					
Balance at December 31, 1996............	19,583	--	--	--	2,546
Net income............................	--	--	--	--	744
Foreign currency translation adjustment	--	--	--	--	--
Termination of redemption privileges for 20,843 shares of redeemable common stock	167	--	--	--	--
Issuance of 223,626 shares of common stock...............................	1,088	--	--	--	--
Comprehensive income....................					
Balance at December 31, 1997............	20,838	--	--	--	3,290
Net loss..............................	--	--	--	--	(217)
Foreign currency translation adjustment	--	--	--	--	--
Issuance of 241,145 shares of common stock...............................	1,494	--	--	--	--
Comprehensive income....................					
Balance at December 31, 1998............	$ 22,332	$ --	$ --	$ --	$ 3,073

</TABLE>

<TABLE>
<CAPTION>

In thousands, except share data	SUBSCRIPTIONS RECEIVABLE	CUMULATIVE TRANSLATION ADJUSTMENT	TOTAL	COMPREHENSIVE INCOME
<S>	<C>	<C>	<C>	<C>
Balance at December 31, 1995............	$ (10)	$ 32	$ 1,334	
Net income............................	--	--	2,071	$ 2,071
Foreign currency translation adjustment	--	24	24	24
Issuance of 11,250 shares of Class B common stock.........................	--	--	3	
Exercise of Class A common stock warrants and issuance of 81,060 shares of Class A common stock..............	--	--	60	
Conversion of 354,932 shares of Convertible preferred stock into 484,758 shares of Class A common stock	--	--	--	
Conversion of 1,178,865 shares of Class B common stock and 2,700,772 shares of Class A common stock into 3,879,637 shares of no par common stock.........	--	--	--	
Termination of redemption privileges for 86,486 shares of redeemable common stock	--	--	692	
Issuance of 1,880,798 shares of common stock...............................	--	--	17,991	
Collections on subscriptions receivable	10	--	10	

Comprehensive income....................				$ 2,095
Balance at December 31, 1996............	--	56	22,185	
Net income............................	--	--	744	$ 744
Foreign currency translation adjustment	--	(214)	(214)	(214)
Termination of redemption privileges for 20,843 shares of redeemable common stock	--	--	167	
Issuance of 223,626 shares of common stock................................	--	--	1,088	
Comprehensive income....................				$ 530
Balance at December 31, 1997............	--	(158)	23,970	
Net loss..............................	--	--	(217)	$ (217)
Foreign currency translation adjustment	--	353	353	353
Issuance of 241,145 shares of common stock................................	--	--	1,494	
Comprehensive income....................				$ 136
Balance at December 31, 1998............	$ --	$ 195	$ 25,600	

</TABLE>

The accompanying notes are an integral part of these consolidated statements.

MECHANICAL DYNAMICS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 1998, 1997 AND 1996

<TABLE>
<CAPTION>

In thousands	1998	1997	1996
<S>	<C>	<C>	<C>
Cash flows from operating activities:			
Net income (loss)	$ (217)	$ 744	$ 2,071
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Acquisition-related costs and non-recurring charges	1,748	1,690	--
Depreciation and amortization	1,726	968	603
(Gain) loss on disposal of assets	64	33	(11)
Minority interest in net income (loss) of subsidiaries	10	(5)	--
Changes in assets and liabilities, net of effect of acquisitions:			
Accounts receivable	(2,245)	(2,304)	(548)
Prepaid and deferred expenses	(273)	(22)	(179)
Other assets	117	(45)	19
Accounts payable	452	499	102
Accrued expenses	(134)	580	200
Deferred revenue	(327)	551	(19)
Net cash provided by operating activities	921	2,689	2,238
Cash flows from investing activities:			
Purchases of property and equipment	(2,250)	(2,177)	(866)
Purchase of technology from the University of Iowa	(400)	--	--
Acquisition of DTI Asia Pte. Ltd., net of cash acquired	(563)	--	--
Acquisition of certain assets of HGE, Inc., net of cash acquired ..	(2,040)	--	--
Acquisition of StatDesign Inc., net of cash acquired	--	(1,374)	--
Net cash used in investing activities	(5,253)	(3,551)	(866)
Cash flows from financing activities:			
Proceeds from issuance of common stock	402	220	18,054
Net borrowings (payments) under line of credit agreements	60	--	(37)
Minority investment in consolidated subsidiary and other	--	467	10
Net cash provided by financing activities	462	687	18,027
Effect of exchange rate changes on cash	452	(134)	30
Net increase (decrease) in cash	(3,418)	(309)	19,429
Cash at beginning of year	20,261	20,570	1,141

Cash at end of year	$ 16,843	$ 20,261	$ 20,570

</TABLE>

Supplemental schedule of non-cash investing and financing activities: Details of acquisitions:

	DTI	STATDESIGN
Net assets (liabilities), excluding cash acquired	$ (59)	$ 22
Purchase price in excess of net assets acquired	734	530
Purchased in-process research and development	980	1,690
Common stock issued	(1,092)	(868)
Net cash used	$ 563	$ 1,374

	HGE, INC.
Net liabilities, excluding cash acquired	$ (118)
Purchase price in excess of net assets acquired	1,955
Purchased in-process research and development	203
Net cash used	$ 2,040

The accompanying notes are an integral part of these consolidated statements.

MECHANICAL DYNAMICS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Mechanical Dynamics, Inc. (the "Company") and its subsidiaries develop, market and support virtual prototyping software and provide consulting, training, and maintenance services to the automotive, aerospace, defense, rail, general machinery and other industries on a worldwide basis.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

In August 1998, the Company established a Canadian subsidiary, Mechanical Dynamics Ltd. ("MDI-Canada"). Immediately following its formation, MDI-Canada acquired the Design Analysis Group and certain other assets of H.G.E. Inc. (see Note 2).

In April 1997, the Company established a Japanese subsidiary, Mechanical Dynamics Japan K.K. ("MDI-Japan"), through a joint venture agreement with Information Services International-Dentsu, Ltd. ("ISI-Dentsu") of Tokyo, Japan, the distributor of the Company's software in Japan. The Company owns 66% of MDI-Japan, while ISI-Dentsu owns a 34% minority interest.

Foreign Currency

The financial statements of international subsidiaries are translated using exchange rates in effect at period end for assets and liabilities and at average rates during the period for results of operations. The resulting foreign currency translation adjustments are reflected as a separate component of shareholders' equity. Foreign currency transaction gain (loss) amounted to

$64,000, ($129,000) and ($31,000) in 1998, 1997 and 1996, respectively, and is included in other income, net in the accompanying consolidated statements of income.

Revenue

Software licenses revenue consists primarily of license fees for the Company's software products and, to a lesser extent, license fees from other companies' software products licensed through the Company's European and Canadian subsidiaries. Revenue under paid-up software licensing agreements, including licenses generated through distributors, is recognized when a customer contract is fully executed and the software is delivered. Revenue under annual software licensing arrangements is deferred and amortized over the terms of the agreements. In either instance, revenue is recognized only when no significant remaining obligations to the customer exist.

Services revenue consists primarily of revenue from software maintenance agreements and professional services, including consulting, training and funded research and development. Revenue related to advance payments received under software maintenance agreements is deferred and amortized over the terms of the agreements. Revenue from other services is recognized upon performance of the service.

Cost of Revenue

Cost of software licenses includes software royalty fees, media costs, payroll and other costs attributable to software documentation and distribution and an allocation of depreciation, utilities and other overhead expenses incurred by the Company.

Cost of services includes payroll and overhead expenses attributable to hotline support, consulting, training and funded research and development.

Research and Development Expenses

Research and development expenses include all payroll costs attributable to research and development activities. Research and development expenses also include an allocation of overhead expenses incurred by the Company.

Under the criteria set forth in Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," capitalization of software development costs begins upon the establishment of technological feasibility of the product. The establishment of technological feasibility and the ongoing assessment of the recoverability of these costs require considerable judgment by management with respect to certain external factors, including, but not limited to, anticipated future gross product revenue, estimated economic product lives and changes in software and hardware technology. Amounts that would have been capitalized under this statement after consideration of the above factors were immaterial, and therefore no software development costs have been capitalized by the Company.

Cash and Cash Equivalents

The Company considers all highly liquid investments with initial maturities of 90 days or less to be cash equivalents.

Property and Equipment

Property and equipment is stated at cost. Office furniture and equipment is depreciated using accelerated or straight-line methods over estimated useful lives of three to seven years. Leasehold improvements are amortized using the straight-line method over the lesser of the respective asset's life or the life of the related lease, generally ten years. Property and equipment consists primarily of office furniture and equipment.

Goodwill

Goodwill represents the unamortized cost in excess of fair value of net assets acquired and is amortized on a straight-line basis over five to fifteen years. On an ongoing basis, management reviews the valuation and amortization of goodwill. As part of this review, the Company considers the value of projected future undiscounted cash flows attributable to the acquired operations in evaluating potential impairment.

Fair Value of Financial Instruments and Concentration of Credit Risk

The Company, at various times, enters into forward exchange contracts to hedge certain exposures related to identifiable foreign currency transactions that are relatively certain as to both timing and amount. Gains and losses on the forward contracts are recognized concurrently with the gains and losses from the underlying transactions. The forward exchange contracts used are classified as "held for purposes other than trading." The Company does not use any other types of derivative financial instruments to hedge such exposures, nor does it use derivatives for speculative purposes. At December 31, 1998, the Company had forward foreign currency exchange contracts of $1.2 million (notional amounts). The contracts outstanding at December 31, 1998 mature through June 7, 1999 and are intended to hedge various foreign currency commitments due from the Company's foreign subsidiaries and international distributors. The fair value of the outstanding contracts is not materially different from their notional amount at December 31, 1998. The Company did not engage in hedging activities prior to 1998.

Other financial instruments which potentially expose the Company to concentrations of credit risk, as defined by Statement of Financial Accounting Standards No. 105, consist primarily of accounts receivable. The Company's accounts receivable are concentrated in global automotive-related companies, other manufacturers and the

Company's international distributor network. The Company generally does not require collateral upon delivery of its products.

Net Income (Loss) Per Common Share

Effective December 31, 1997, the Company adopted Statement of Financial Accounting Standards No. 128, "Earnings per Share." All prior period per share data presented has been restated to conform to this new statement. The following table reconciles the weighted average number of shares in the basic net income (loss) per common share calculation to the number of shares in the diluted net income (loss) per common share calculation:

<TABLE>
<CAPTION>

	YEAR ENDED DECEMBER 31, 1998	1997	1996
<S>	<C>	<C>	<C>
Weighted average common shares used in basic net income (loss) per common share	6,186,469	5,805,936	4,990,215
Effect of stock options	--	61,817	79,813
Weighted average common and common equivalent shares used in diluted net income (loss) per common share	6,186,469	5,867,753	5,070,028

</TABLE>

For the year ended December 31, 1998, the dilutive effect of stock options outstanding for the purchase of 95,020 shares was not included in the net income (loss) per common share calculation because doing so would have been anti-dilutive.

Comprehensive Income

Effective January 1, 1998, the Company adopted Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income," which establishes standards for reporting and display of comprehensive income and its components in a full set of financial statements. Comprehensive income is the total of net income and all other non-owner changes in equity. The difference between net income (loss), as reported in the accompanying consolidated statements of income, and comprehensive income is the foreign currency translation adjustment for the respective periods. The accumulated other comprehensive income (loss) consists solely of the cumulative translation adjustment as presented in the accompanying consolidated balance sheets.

Stock-Based Compensation

The Company has elected to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees", and related interpretations. Accordingly, compensation cost for stock options is measured as the excess, if any, of the quoted market price of the Company's stock at the date of grant over the amount the employee must pay to acquire the stock in the accompanying consolidated statements of income. As supplemental information, the Company has provided pro forma disclosure of the fair value at the date of grant of stock options granted during 1998 and 1997 in Note 5, in accordance with the requirements of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123").

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

New Accounting Pronouncements

Effective January 1, 1998, the Company adopted Statement of Position 97-2, "Software Revenue Recognition," which provides guidance on recognizing revenue on software transactions. The implementation of this statement did not have an effect upon the Company's consolidated financial statements or its existing revenue recognition policies.

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"). SFAS 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and hedging activities. It requires that an entity record all derivatives as either assets or liabilities at fair value. Under certain conditions, a derivative may be designated as a hedge of (1) potential changes in the fair value of an asset or liability or firm commitment, (2) the foreign currency exposure of a forecasted transaction, or (3) the foreign currency exposure of the net investment in a foreign operation. The accounting for changes in the fair value of a derivative instrument depends on the intended use of the derivative and the resulting designation. The statement is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. The Company's derivative activities are currently limited to entering into forward contracts to hedge potential changes in the fair value of its receivables denominated in certain foreign currencies.

Reclassifications

Certain amounts in the 1997 and 1996 consolidated financial statements have been reclassified to conform with the 1998 presentation.

(2) ACQUISITIONS

In November 1998, the Company formed a strategic partnership with the University of Iowa in which component-level durability sensitivity analysis technology developed by the University was acquired and will be integrated with the Company's ADAMS virtual prototyping software to provide system-level durability design sensitivity analysis capabilities. In connection with the transaction, the Company reported a non-recurring charge to operations in 1998 of $400,000, associated with the write-off of in-process research and development acquired from the University. The purchase price was allocated to in-process research and development as the software had not reached technological feasibility and no other tangible or intangible assets were identified.

In August 1998, the Company acquired the Design Analysis Group and certain other assets of H.G.E. Inc. ("HGE"), an engineering software and services firm based in Toronto, Ontario, Canada. The aggregate purchase price of approximately $2.2 million consisted principally of cash. The acquisition has been accounted for under the purchase method of accounting. In connection with the acquisition, the Company recorded a non-recurring charge to operations in 1998 of approximately $203,000, associated with the write-off of in-process research and development acquired in the transaction which had not reached technological feasibility. The remaining excess of the aggregate purchase price over the fair value of the net assets acquired has been recognized as goodwill and is being amortized over a twelve-year period. The operating results of the Design Analysis Group have been included in the Company's consolidated results of operations from the date of acquisition.

In January 1998, the Company acquired 100% of the outstanding capital stock of DTI Asia Pte. Ltd. ("DTI"), a provider of mechanical design simulation software embedded in the AutoCAD and Mechanical Desktop product lines from Autodesk, Inc. The aggregate purchase price of approximately $1.7 million consisted of $563,000 in cash and 142,540 shares of the Company's common stock valued at approximately $1.1 million. The acquisition has been accounted for under the purchase method of accounting. In connection with the acquisition, the Company recorded a non-recurring charge to operations in 1998 of approximately $980,000, associated with the write-off of in-process research and development acquired in the transaction which had not reached technological feasibility. The remaining excess of the aggregate purchase price over the fair value of the net assets acquired has been recognized as goodwill and will be amortized over a five-year period. The operating results of DTI have been included in the Company's consolidated results of operations from the date of acquisition.

In October 1997, the Company acquired 100% of the outstanding capital stock of StatDesign, Inc., a company based in Dearborn, Michigan. Since its founding in 1992, StatDesign, Inc. had worked almost exclusively with the Company's largest single customer to provide engineering software and services for product design and development. The aggregate purchase price of approximately $2.2 million consisted of $1.4 million in cash and 170,227 shares of the Company's common stock valued at approximately $868,000. The acquisition has been accounted for under the purchase method of accounting. In connection with the acquisition, the Company recorded a non-recurring charge to operations in 1997 of approximately $1.7 million, associated with the write-off of in-process research and development acquired in the transaction which had not reached technological feasibility. The remaining excess of the aggregate purchase price over the fair value of the net assets acquired of approximately $530,000 has been recognized as goodwill and will be amortized over a ten-year period. The operating results of StatDesign, Inc. have been included in the Company's consolidated results of operations from the date of acquisition.

(3) FINANCING ARRANGEMENTS

The Company has available an unsecured bank line of credit with a maximum borrowing capacity of $4.0 million. Borrowings on the line of credit bear interest at 0.75% below the bank's prime rate of interest. No borrowings were outstanding at December 31, 1998. The agreement expires on June 30, 2000.

The Company's subsidiaries in Italy, Sweden and France also have line of credit and overdraft facilities that provide for aggregate borrowing availability of approximately $260,000, at various fixed and variable interest rates at December 31, 1998. Borrowings are primarily due on demand and are collateralized by certain assets of the subsidiaries. Borrowings outstanding under these agreements were $105,000 and $45,000 at December 31, 1998 and 1997, respectively.

No borrowings were outstanding under long-term debt arrangements at December 31, 1998 and 1997. Cash paid for interest was $16,000, $12,000 and $22,000 in 1998, 1997 and 1996, respectively.

(4) INCOME TAXES

A summary of income before provision for income taxes and components of the provision for income taxes is as follows:

<TABLE>
<CAPTION>

In thousands	YEAR ENDED DECEMBER 31, 1998	1997	1996
Income (loss) before provision for income taxes:			
Domestic	$ 940	$ 1,497	$ 2,874
Foreign	(668)	259	165
	$ 272	$ 1,756	$ 3,039
Domestic provision (benefit) for income taxes:			
Current	$ 241	$ 859	$ 973
Deferred	30	42	(92)
Foreign provision for income taxes:			
Current	208	116	87
Provision for income taxes	$ 479	$ 1,017	$ 968

</TABLE>

The differences between the income tax provision calculated at the United States federal statutory rate and the consolidated income tax provision are summarized as follows:

In thousands	YEAR ENDED DECEMBER 31, 1998	1997	1996
Federal statutory provision	$ 92	$ 597	$ 1,033
Meals and entertainment	33	41	28
Acquisition-related costs and non-recurring charges	402	575	--
Goodwill amortization	44	35	33
Reduction in valuation reserve	--	--	(95)
Foreign losses without tax benefit	--	5	5
Effect of differences between U.S. and foreign tax rates	37	(66)	31
Tax-exempt interest income	(121)	(106)	(34)
Other, net	(8)	(64)	(33)
Provision for income taxes	$ 479	$ 1,017	$ 968

Deferred income taxes represent temporary differences in the recognition of certain items for income tax and financial reporting purposes. The components of the net deferred income tax asset are summarized as follows:

In thousands	AS OF DECEMBER 31, 1998	1997
Deferred tax assets:		
Property and equipment	$ 28	$ 81
Employee benefits	131	120
Accounts receivable	89	72
Other	(5)	--
Net deferred tax asset	$ 243	$ 273

Income taxes have been provided on all undistributed earnings of foreign subsidiaries. Cash paid for income taxes was $1.2 million, $764,000 and $753,000 in 1998, 1997 and 1996, respectively.

(5) REDEEMABLE COMMON STOCK AND SHAREHOLDERS' EQUITY

On April 23, 1996, the shareholders of the Company approved an amendment and restatement to the Company's articles of incorporation that effected (1) a 1.5-for-1 stock split of the Company's common stock, (2) an increase in the authorized shares of common stock to 15,000,000 shares, (3) the conversion of all classes of common stock to no par common stock, (4) an increase in the authorized number of preferred shares to 1,000,000, and (5) an amendment of the privileges of the preferred stock. All references in the consolidated financial statements and accompanying notes have also been adjusted to reflect the amendment and restatement of the articles of incorporation.

Common Stock

Holders of shares of common stock are entitled to one vote per share on all matters submitted to a vote of holders of shares of common stock, and do not have any cumulative voting rights. In the event of a liquidation, dissolution or winding-up of the Company, the holders of shares of common stock are entitled to share equally and ratably in the assets of the Company, if any, remaining after the payment of debts and liabilities of the Company, subject to prior liquidation rights of any outstanding shares of preferred stock.

In May 1996, the Company completed an initial public offering of its stock, which resulted in the issuance of 1,500,000 shares of common stock at a price of $11.00 per share. In June 1996, an additional 354,750 shares were sold by the Company at $11.00 per share, pursuant to the underwriters' exercise of their over-allotment option.

In November 1998, the Board of Directors authorized management of the

Company to repurchase up to 500,000 shares of the Company's common stock. No shares have been repurchased to date.

Preferred Stock

The Board of Directors is authorized to issue up to 1,000,000 shares of preferred stock in one or more series. Under each issuance of a series of preferred stock, the Board of Directors is permitted to fix the designations, preferences, powers and relative rights and restrictions thereof, including without limitation, the dividend rate, conversion rights, voting rights, redemption price, and liquidation preference.

Convertible Preferred Stock

On February 8, 1996, the Board of Directors authorized the Company to redeem all outstanding shares of convertible preferred stock. The holders of convertible preferred shares had the right to convert such shares into shares of Class A common stock in lieu of accepting cash redemption payments. As of April 11, 1996, all holders of convertible preferred stock exercised their right to convert their shares into Class A common stock. Based on a formula in the agreement, each share of convertible preferred stock was converted into approximately 1.37 shares of Class A common stock.

Class A and Class B Common Stock

In April 1996, the Company amended and restated its Articles of Incorporation to automatically convert each share of Class A common stock and each share of Class B common stock into one share of common stock.

In April 1994, the Company purchased all of the outstanding stock of its distributors in France, Germany, Sweden, Italy and the United Kingdom. In connection with this acquisition, the Company issued 107,329 shares of Class A common stock with redemption privileges at $8 per share. During 1997 and 1996, the redemption privileges associated with 20,843 and 86,486 of these shares terminated, respectively.

Class A Common Stock Warrants

In March 1990, April 1991, and September 1992, 124,155, 23,280, and 14,685 nonnegotiable warrants to acquire Class A common stock of the Company, respectively, were issued and attached to the Company's subordinated debt. The Company was notified on March 11, 1996, that the holder of one-half of the warrants would exercise their right to purchase 81,060 shares of the Company's Class A common stock at a price of $0.75 per share. The remaining warrants were redeemed by the Company in 1996 for a cash value of $449,000.

Employee Stock Purchase Plan

The Company's Employee Stock Purchase Plan (the "Purchase Plan") was adopted by the Company's Board of Directors in March 1996. A total of 300,000 shares of common stock have been reserved for issuance under the Purchase Plan. The Purchase Plan provides that the Company will sell shares to employees who elect to participate in the Purchase Plan at a price equal to 85% of the lesser of the fair market value of the common stock on the first trading day of an offering period or the last trading day of such offering period.

Under the Purchase Plan, the Company issued 43,340, 33,899 and 17,213 shares of common stock in 1998, 1997 and 1996, respectively, to various employees. These shares were issued with a weighted average price per share of $6.37, $5.97 and $11.79 in 1998, 1997 and 1996, respectively. As of December 31, 1998, there were 205,548 shares of common stock remaining to be issued under this plan.

1996 Stock Incentive Plan For Key Employees

The Company's 1996 Stock Incentive Plan for Key Employees (the "Stock Option Plan") was adopted by the Company's Board of Directors in March 1996. Under the Stock Option Plan, options will be granted or restricted stock will be awarded for the purpose of attracting and motivating key employees of the Company. The Stock Option Plan provides for (1) the grant of "incentive stock options" within the meaning of Section 422 of the Internal

Revenue Code, (2) the grant of "nonqualified stock options" (options which do not meet the requirements of Section 422), and (3) the award of restricted stock. Subject to certain provisions outlined in the Stock Option Plan, the Compensation Committee of the Board of Directors will determine which key employees will be granted options or awarded restricted stock, the number of options granted or shares awarded, and other terms and conditions applicable to each award or grant. A total of 650,000 shares of common stock have been reserved for issuance under the Stock Option Plan.

Stock option activity for this plan is summarized below:

	NUMBER OF SHARES	PRICE PER SHARE	WTD. AVG. EXERCISE PRICE
Outstanding at December 31, 1995	--	--	--
Granted	182,500	$9.00 - $13.50	$ 11.47
Outstanding at December 31, 1996	182,500	$9.00 - $13.50	$ 11.47
Granted	329,000	$6.50 - $ 9.13	$ 7.75
Canceled	(132,200)	$6.50 - $13.50	$ 11.81
Outstanding at December 31, 1997	379,300	$6.69 - $ 9.13	$ 8.12
Granted	564,150	$6.75 - $11.50	$ 7.76
Exercised	(6,125)	$6.75 - $ 9.00	$ 8.84
Canceled	(347,800)	$6.75 - $11.50	$ 9.61
Outstanding at December 31, 1998	589,525	$6.69 - $11.50	$ 7.38

There were 68,925 and 82,500 options exercisable under the Stock Option Plan as of December 31, 1998 and 1997, respectively, with a weighted average exercise price of $8.21 per share in 1998 and $9.00 per share in 1997. The remaining options vest over a three or four year period beginning on the date of grant at 33% or 25% per year, respectively, and expire five or ten years from the date they are granted. As of December 31, 1998, there were 54,350 shares of common stock remaining to be issued under the Stock Option Plan. Options outstanding under the Stock Option Plan have a weighted average remaining contractual life of 7.6 years and 4.1 years as of December 31, 1998 and 1997, respectively.

In November 1998, the Board of Directors approved a one-for-one stock option exchange that provided non-director employees with the opportunity to exchange stock options previously granted for new options with a current market price and a new vesting period. The new options were priced at $6.75 per share based on the closing price of the Company's common stock as reported on Nasdaq on November 10, 1998, vest in equal installments over three years from the November 10, 1998 grant date and expire on November 10, 2008. The repriced options can only be exercised when the closing price of the Company's common stock equals or exceeds $11.00 per share. A total of 335,950 options with prior exercise prices ranging from $6.75 to $11.50 per share were exchanged. The weighted average prior exercise price of options exchanged was $8.81 per share. The exchange of such options is presented in the table above as cancellations and subsequent grants.

Non-Employee Director Stock Option Plan

The Company's Non-Employee Director Stock Option Plan (the "Director Stock Option Plan") was adopted by the Company's Board of Directors in March 1996. The Director Stock Option Plan provides for the grant of "nonqualified stock options" to purchase shares of common stock. Upon appointment to the Board of Directors, each newly appointed non-employee director will receive an option to purchase 5,000 shares of common stock of the Company. Furthermore, immediately following each annual meeting of shareholders of the Company, each non-employee director who has served as a director for at least six months will automatically be granted an option to purchase 5,000 shares of common stock of the Company. The exercise price of any option will be equal to the market price of the common stock at the time of grant. Each option, if not terminated sooner as provided in the Director Stock Option Plan, will have a five-year term from the date of grant and will vest and become exercisable in full on the first anniversary of the date of grant. A total of 100,000 shares of common stock have been reserved for issuance under the Director Stock Option Plan.

Stock option activity for this plan is summarized below:

<TABLE>
<CAPTION>

	NUMBER OF SHARES	PRICE PER SHARE	WTD. AVG. EXERCISE PRICE
Outstanding at December 31, 1995	--	--	--
Granted	20,000	$ 11.00	$11.00
Outstanding at December 31, 1996	20,000	$ 11.00	$11.00
Granted	20,000	$ 9.13	$ 9.13
Outstanding at December 31, 1997	40,000	$ 9.13 - $11.00	$10.07
Granted	20,000	$ 13.00	$13.00
Outstanding at December 31, 1998	60,000	$ 9.13 - $13.00	$11.04

</TABLE>

There were 40,000 and 20,000 options exercisable under the Director Stock Option Plan as of December 31, 1998 and 1997, respectively, with a weighted average exercise price of $10.07 per share in 1998 and $11.00 per share in 1997. Options outstanding under the Director Stock Option Plan have a weighted average remaining contractual life of 3.4 years and 3.8 years as of December 31, 1998 and 1997, respectively.

1993 Stock Option Plan

In March 1996, the Company's 1993 Stock Option Plan (the "1993 Plan") was terminated by the Board of Directors. Under the 1993 Plan, the Board was permitted to grant options to purchase shares of Class A common stock to certain key employees. The price of such options was determined by the Board when the options were granted, but could not be less than the book value of the stock. Management determined that all options granted under the 1993 Plan were at exercise prices equal to or in excess of fair market value. Stock option activity for this plan is summarized below:

<TABLE>
<CAPTION>

	NUMBER OF SHARES	PRICE PER SHARE
Outstanding at December 31, 1995 and 1996	61,671	$ 0.93
Exercised	(19,500)	$ 0.93
Outstanding at December 31, 1997	42,171	$ 0.93
Exercised	(42,171)	$ 0.93
Outstanding at December 31, 1998	--	

</TABLE>

For various price ranges, information for options outstanding and exercisable for all option plans at December 31, 1998 was as follows:

<TABLE>
<CAPTION>

	OUTSTANDING OPTIONS			EXERCISABLE OPTIONS	
RANGE OF EXERCISE PRICES	SHARES	WTD. AVG. REMAINING LIFE (YEARS)	WTD. AVG. EXERCISE PRICE	SHARES	WTD. AVG. EXERCISE PRICE
$6.69 - $7.00	356,075	9.56	$ 6.75	5,050	$ 6.72
$ 7.01 - $8.00	148,500	3.19	$ 7.86	37,125	$ 7.86
$ 8.01 - $9.00	32,250	2.82	$ 8.90	26,750	$ 8.97
$ 9.01 - $11.00	91,700	6.38	$ 9.63	40,000	$ 10.07
$ 11.01 - $13.00	21,000	4.61	$ 12.93	--	--

</TABLE>

Stock-Based Compensation

Using the intrinsic value method of accounting for the value of stock options granted during 1998 and 1997, no compensation cost was recorded in the accompanying consolidated statements of income. Had compensation cost been determined based on the fair value at the date of grant for awards in 1998 and 1997 consistent with the provisions of SFAS 123, net income and net income per share would have been reduced to the pro forma amounts indicated below:

In thousands, except per share data	1998	1997
Net income (loss) - as reported	$(217)	$ 744
Net income (loss) - pro forma	$(963)	$ 406
Diluted net income (loss) per share - as reported	$(0.04)	$ 0.13
Diluted net income (loss) per share - pro forma	$(0.16)	$ 0.07

The weighted average estimated fair value of stock options granted during 1998 and 1997 was $4.69 and $3.98, respectively. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model. The following weighted average assumptions were used in valuing the option grants:

	1998	1997
Expected life (years)	5.0	5.0
Interest rate	5.2%	6.0%
Volatility	0.7	0.8
Dividend yield	0.0%	0.0%

(6) COMMITMENTS AND CONTINGENCIES

Employee Benefit Plans

The Company maintains a 401(k) plan covering substantially all of its employees. During 1998, 1997 and 1996, the Company matched 40% of qualified employee contributions, up to a maximum of 2.4% of eligible compensation. In 1998, 1997 and 1996, the Company contributed $244,000, $180,000 and $150,000, respectively, to the plan.

Lease Commitments

The Company and its subsidiaries lease office space and certain equipment under noncancelable operating lease agreements. Future minimum lease payments at December 31, 1998 are as follows:

In thousands	
1999	$ 1,653
2000	866
2001	196
2002	135
2003	15
Thereafter	13
	$ 2,878

Total lease expense amounted to approximately $2.0 million in each of the years ending 1998, 1997 and 1996.

Royalty Agreements

The Company has entered into various agreements which generally provide for royalty payments by the Company based on a percentage of revenue derived through the licensing of certain software products. Royalty expense under these agreements amounted to approximately $2.2 million, $612,000 and $480,000 in 1998, 1997 and 1996, respectively.

(7) LITIGATION

The Company is party to routine litigation arising in the normal course of business. In the opinion of management, the liabilities resulting from these proceedings, if any, will not be material to the Company's consolidated financial position or results of operations.

(8) GEOGRAPHIC OPERATIONS AND SEGMENT INFORMATION

Effective December 31, 1998, the Company adopted Statement of Financial Accounting Standards No. 131, "Disclosures About Segments of an Enterprise and Related Information" ("SFAS 131"). SFAS 131 introduces a new model for segment reporting called the "management approach." The management approach is based on the way that the chief operating decision-maker organizes segments within a company for making operating decisions and assessing performance.

The Company operates in one segment - the development, marketing and support of software products and services for the mechanical segment of the computer-aided engineering industry. The Company licenses products to customers on a worldwide basis. Sales and marketing operations outside the United States are conducted principally through the Company's foreign subsidiaries and international distributors. Intercompany sales and transfers between geographic areas are accounted for at prices which are designed to be representative of third party transactions.

The following table summarizes selected financial information of the Company's operations by geographic location:

<TABLE>
<CAPTION>

In thousands	YEAR ENDED DECEMBER 31, 1998	1997	1996
<S>	<C>	<C>	<C>
Revenue:			
North America			
United States	$ 12,223	$ 10,340	$ 8,250
Canada and Mexico	1,514	153	128
Europe			
Germany	5,108	4,380	4,217
Other European countries	7,769	5,653	5,535
Asia/Pacific			
Japan	7,819	7,324	5,424
Other Asian countries	2,142	2,341	1,829
Total revenue	$ 36,575	$ 30,191	$ 25,383
Operating contribution:			
North America			
United States	$ 3,827	$ 3,229	$ 2,940
Canada and Mexico	186	89	87
Europe			
Germany	1,805	1,377	1,315
Other European Countries	2,672	1,836	1,686
Asia/Pacific			
Japan	1,204	2,020	1,953
Other Asian countries	250	623	658
Total operating contribution	9,944	9,174	8,639
Unallocated expenses, net	(9,672)	(7,418)	(5,600)
Income before taxes and minority interest	$ 272	$ 1,756	$ 3,039
Identifiable assets:			
North America			
United States	$ 23,882	$ 26,115	$ 24,744
Canada	1,698	--	--
Europe			
Germany	1,942	1,124	1,199

Other European countries	3,430	3,580	2,797
Asia/Pacific			
Japan	1,362	1,788	--
Other Asian countries	114	42	--
Total identifiable assets	32,428	32,649	28,740
Goodwill	3,819	1,498	1,072
Total assets	$ 36,247	$ 34,147	$ 29,812

</TABLE>

No customer accounted for greater than 10% of total revenue in 1998. One customer accounted for approximately 10.6% and 11.8% of total revenue in 1997 and 1996, respectively.

Unallocated expenses, net consist of general corporate expenses, internal research and product development expenses, interest expense and interest income. In 1998 and 1997, these expenses also include acquisition and related costs of approximately $1.7 million.

(9) QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

The following table summarizes selected unaudited quarterly financial information for 1998 and 1997. The Company believes all adjustments, consisting of normal recurring adjustments considered necessary for a fair presentation, have been included in the selected quarterly information:

<TABLE>
<CAPTION>

In thousands, except per share data	THREE MONTHS ENDED MARCH 31, 1998	JUNE 30, 1998	SEPTEMBER 30, 1998	DECEMBER 31, 1998	YEAR ENDED DECEMBER 31, 1998
<S>	<C>	<C>	<C>	<C>	<C>
Revenue	$ 8,735	$ 8,905	$ 8,180	$ 10,755	$ 36,575
Gross profit	6,027	6,327	5,077	7,084	24,515
Operating income (loss)	(554)	847	(939)	90	(556)
Net income (loss)	(613)	733	(586)	249	(217)
Basic net income (loss) per common share	$ (0.10)	$ 0.12	$ (0.09)	$ 0.04	$ (0.04)
Diluted net income (loss) per common share	$ (0.10)	$ 0.12	$ (0.09)	$ 0.04	$ (0.04)

</TABLE>

<TABLE>
<CAPTION>

In thousands, except per share data	THREE MONTHS ENDED MARCH 31, 1997	JUNE 30, 1997	SEPTEMBER 30, 1997	DECEMBER 31, 1997	YEAR ENDED DECEMBER 31, 1997
<S>	<C>	<C>	<C>	<C>	<C>
Revenue	$ 6,701	$ 7,205	$ 7,679	$ 8,606	$30,191
Gross profit	4,994	5,358	5,802	6,180	22,334
Operating income (loss)	514	628	693	(870)	965
Net income (loss)	477	589	649	(971)	744
Basic net income (loss) per common share	$ 0.08	$ 0.10	$ 0.11	$ (0.16)	$ 0.13
Diluted net income (loss) per common share	$ 0.08	$ 0.10	$ 0.11	$ (0.16)	$ 0.13

</TABLE>

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

PART III

Certain information required by Part III is omitted from this report in that the Registrant will file a definitive proxy statement pursuant to Regulation 14A (the "Proxy Statement") not later than 120 days after the end of the fiscal year covered by this report and certain information included therein is incorporated herein by reference. Only those sections of the Proxy Statement that specifically address the items set forth herein are incorporated by reference.

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information with respect to the directors of the Company is incorporated by reference to the Company's Proxy Statement for the 1999 Annual Meeting of Shareholders scheduled to be held on May 13, 1999.

The executive officers of the Company as of March 1, 1999 are listed below:

NAME	AGE	POSITION
Michael E. Korybalski	52	Chief Executive Officer, Chairman of the Board and Director
Robert R. Ryan	41	President, Chief Operating Officer and Director
Michael Hoffmann	42	Senior Vice President -- Worldwide Sales & Service
David Peralta	31	Vice President, Chief Financial Officer and Treasurer

Michael E. Korybalski, a co-founder of MDI, is currently Chief Executive Officer, Chairman of the Board and a director of the Company. From 1984 to February 1997, Mr. Korybalski served as President of the Company. From 1977 to 1984, Mr. Korybalski served as Vice President and General Manager of the Company. From 1973 to 1977, he was employed as a product engineer with Ford Motor Company. Mr. Korybalski holds B.S.E. and M.S.E. degrees in mechanical engineering, as well as an M.B.A., from the University of Michigan.

Robert R. Ryan became the President of the Company in February 1997 and since 1991 has served as the Chief Operating Officer of the Company. Dr. Ryan was elected a director of the Company in May 1997. Dr. Ryan served as the Company's Executive Vice President from 1991 to February 1997. From 1988 through 1991, Dr. Ryan served as the Company's Vice President of Product Development. Before joining the Company, Dr. Ryan held various positions in sales and engineering services at Structural Dynamics Research Corporation, and served briefly on the engineering faculty at the University of Michigan. Dr. Ryan holds a B.S. degree from the University of Cincinnati and M.S. and Ph.D. degrees in applied mechanics from Stanford University.

Michael Hoffmann became the Company's Senior Vice President -- Worldwide Sales and Service in November 1997. Dr. Hoffmann served as the Company's Vice President -- European Operations from November 1996 to November 1997. Dr. Hoffmann served as the Company's Managing Director -- European Operations from 1994 through February 1997. From 1993 through 1994, Dr. Hoffmann served as Managing Director of TEDAS Mechanical Systems GmbH, a shareholder of the Company. From 1991 through 1992, he served as Technical Director of TEDAS GmbH. Dr. Hoffmann holds masters and doctorate degrees in civil engineering from the Technological University of Darmstadt.

David Peralta became the Company's Vice President, Chief Financial Officer and Treasurer in February 1997, and served as Controller of the Company from 1993 to February 1997. From 1992 to 1993, Mr. Peralta served as Assistant Corporate Controller at OVAKO Ajax, Inc. From 1989 through 1992, he served as an auditor at Coopers & Lybrand. Mr. Peralta is a licensed Certified Public Accountant in the State of Michigan. Mr. Peralta holds a bachelors degree in accounting from the University of Michigan.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated by reference to the Company's Proxy Statement for the 1999 Annual Meeting of Shareholders scheduled to be held on May 13, 1999.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this Item is incorporated by reference to the Company's Proxy Statement for the 1999 Annual Meeting of Shareholders scheduled to be held on May 13, 1999.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

None.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

ITEM 14(a)1. FINANCIAL STATEMENTS

Report of Independent Public Accountants
Consolidated Balance Sheets as of December 31, 1998 and 1997
Consolidated Statements of Income for the Years Ended December 31, 1998, 1997 and 1996
Consolidated Statements of Shareholders' Equity for the Years Ended December 31, 1998, 1997 and 1996
Consolidated Statements of Cash Flows for the Years Ended December 31, 1998, 1997 and 1996
Notes to Consolidated Financial Statements

ITEM 14(a)2. FINANCIAL STATEMENT SCHEDULES

None.

ITEM 14(a)3. EXHIBITS

<TABLE>
<CAPTION>

NUMBER	EXHIBIT
<S>	<C>
(2)	Joint Venture Agreement between Mechanical Dynamics, Inc. and Information Services International-Dentsu, Ltd., incorporated herein by reference to Exhibit 2 to the Company's previously filed Form 10-Q for the quarter ended March 31, 1997
(3.1)	Restated Articles of Incorporation, incorporated herein by reference to Exhibit 3.2 to the Company's previously filed Registration Statement on Form S-1, Registration No. 333-2900
(3.2)	Restated Bylaws, incorporated herein by reference to Exhibit 3.4 to the Company's previously filed Registration Statement on Form S-1, Registration No. 333-2900
(4.2)	Line of Credit Demand Note between KeyBank National Association and the Company dated December 4, 1998
(10.1)	Employment Agreement between the Company and Michael E. Korybalski, as amended
(10.2)	Employment Agreement between the Company and Robert R. Ryan, as amended
(10.3)	Employment Agreement between the Company and David Peralta, as amended
(11)	Statement Re Computation Of Per Share Earnings Per Share
(21)	Subsidiaries Of The Registrant
(23.1)	Consent Of Independent Public Accountants
(27) - 1998	Financial Data Schedule - 1998
(27) - 1996	Financial Data Schedule - 1996 (Amended for SFAS 128)
(27) - 1997-Q3	Financial Data Schedule - 1997 - 3rd Quarter (Amended for SFAS 128)
(27) - 1996-Q3	Financial Data Schedule - 1996 - 3rd Quarter (Amended for SFAS 128)

</TABLE>

ITEM 14(b). REPORTS ON FORM 8-K

No reports on Form 8-K were filed by the Company during the year ended December 31, 1998.

SIGNATURES

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

Dated: March 26, 1999

MECHANICAL DYNAMICS, INC.
(Registrant)

By: /s/ Michael E. Korybalski

Michael E. Korybalski
Chairman of the Board

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

SIGNATURES	TITLE	DATE
/s/ Michael E. Korybalski Michael E. Korybalski	Chairman of the Board, Chief Executive Officer, and Director (Principal Executive Officer)	March 26, 1999
/s/ Robert R. Ryan Robert R. Ryan	President, Chief Operating Officer and Director	March 26, 1999
/s/ David Peralta David Peralta	Chief Financial Officer (Principal Financial and Accounting Officer)	March 26, 1999
/s/ Herbert S. Amster Herbert S. Amster	Director	March 26, 1999
/s/ David E. Cole David E. Cole	Director	March 26, 1999
/s/ Joseph F. Gloudeman Joseph F. Gloudeman	Director	March 26, 1999
/s/ Mitchell I. Quain Mitchell I. Quain	Director	March 26, 1999

INDEX TO EXHIBITS

NUMBER	EXHIBIT TITLE
(2)	Joint Venture Agreement between Mechanical Dynamics, Inc. and Information Services International-Dentsu, Ltd., incorporated herein by reference to Exhibit 2 to the Company's previously filed Form 10-Q for the quarter ended March 31, 1997

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(4.2)	Line of Credit Demand Note between KeyBank National Association and the Company dated December 4, 1998
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(21)	Subsidiaries Of The Registrant
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(27) - 1998	Financial Data Schedule - 1998
(27) - 1996	Financial Data Schedule - 1996 (Amended for SFAS 128)
(27) - 1997-Q3	Financial Data Schedule - 1997 - 3rd Quarter (Amended for SFAS 128)
(27) - 1996-Q3	Financial Data Schedule - 1996 - 3rd Quarter (Amended for SFAS 128)

</TABLE>

EXHIBIT 4.2

PROMISSORY NOTE

<TABLE>
<S><C>
Principal Amount: $4,000,000.00 Initial Rate: 7.000% Date of Note: December 4, 1998
</TABLE>

PROMISE TO PAY. Mechanical Dynamics, Inc. ("Borrower") promises to pay to KeyBank National Association ("Lender"), or order, in lawful money of the United States of America, on demand, the principal amount of Four Million & 00/100 Dollars ($4,000,000.00) or so much as may be outstanding, together with interest on the unpaid outstanding principal balance of each advance. Interest shall be calculated from the date of each advance until repayment of each advance.

PAYMENT. BORROWER WILL PAY THIS LOAN IMMEDIATELY UPON LENDER'S DEMAND. IN ADDITION, BORROWER WILL PAY REGULAR MONTHLY PAYMENTS OF ALL ACCRUED UNPAID INTEREST DUE AS OF EACH PAYMENT DATE, BEGINNING JANUARY 4, 1999, WITH ALL SUBSEQUENT INTEREST PAYMENTS TO BE DUE ON THE SAME DAY OF EACH MONTH AFTER THAT. Interest on this Note is computed on a 365/360 simple interest basis; that is, by applying the ratio of the annual interest rate over a year of 360 days, times the outstanding principal balance, times the actual number of days the principal balance is outstanding. Borrower will pay Lender at Lender's address shown above or at such other place as Lender may designate in writing. Unless otherwise agreed or required by applicable law, payments will be applied first to accrued unpaid interest, then to principal, and any remaining amount to any unpaid collection costs and late charges.

VARIABLE INTEREST RATE. The interest rate on this Note is subject to change from time to time based on changes in an index which is the KeyBank Prime (the "Index"). The interest rate will change on the date of each announced change of the Index within KeyBank. The Index is not necessarily the lowest rate charged by Lender on its loans and is set by Lender in its sole discretion. If the Index becomes unavailable during the term of this loan, the Lender may designate a substitute index after notifying Borrower. Lender will tell Borrower the current Index rate upon Borrower's request. Borrower understands that Lender may make loans based on other rates as well. The Interest rate change will not occur more often than each day that the rate changes. THE INDEX CURRENTLY IS 7.750% PER ANNUM. THE INTEREST RATE TO BE APPLIED TO THE UNPAID PRINCIPAL BALANCE OF THIS NOTE WILL BE AT A RATE OF 0.750 PERCENTAGE POINTS UNDER THE INDEX, RESULTING IN AN INITIAL RATE OF 7.000% PER ANNUM. NOTICE: Under no circumstances will the interest rate on this Note be more than the maximum rate allowed by applicable law.

PREPAYMENT. Borrower may pay without penalty all or a portion of the amount owed earlier than it is due. Early payments will not, unless agreed to by

Lender in writing, relieve Borrower of Borrower's obligation to continue to make payments of accrued unpaid interest. Rather, they will reduce the principal balance due.

LATE CHARGE. If a regularly scheduled interest payment is 10 DAYS OR MORE LATE, Borrower will be charged 5.000% of the unpaid portion of the REGULARLY SCHEDULED PAYMENT OR $50.00, WHICHEVER IS GREATER. If Lender demands payment of this loan, and Borrower does not pay the loan WITHIN 10 DAYS AFTER LENDER'S DEMAND, BORROWER ALSO WILL BE CHARGED EITHER 5.000% OF THE UNPAID PORTION OF THE SUM OF THE UNPAID PRINCIPAL PLUS ACCRUED UNPAID INTEREST OR $50.00, WHICHEVER IS GREATER.

DEFAULT. Borrower will be in default if any of the following happens: (a) Borrower fails to make any payment when due. (b) Borrower breaks any promise Borrower has made to lender, or Borrower fails to comply with or to perform when due any other term, obligation, covenant, or condition contained in this Note or any agreement related to this Note, or in any other agreement or loan Borrower has with Lender. (c) Borrower defaults under any loan, extension of credit, security agreement, purchase or sales agreement, or any other agreement, in favor of any other creditor or person that may materially affect any of Borrower's property or Borrower's ability to repay this Note or perform Borrower's obligations under this Note or any of the Related Documents. (d) Any representation or statement made or furnished to Lender by Borrower or on Borrower's behalf is false or misleading in any material respect either now or at the time made or furnished. (e) Borrower becomes insolvent, a receiver is appointed for any part of Borrower's property, Borrower makes an assignment for the benefit of creditors, or any proceeding is commenced either by Borrower or against Borrower under any bankruptcy or insolvency laws. (f) Any creditor tries to take any of Borrower's property on or in which Lender has a lien or security interest. This includes a garnishment of any of Borrower's accounts with Lender. (g) Any guarantor dies or any of the other events described in this default section occurs with respect to any guarantor of this Note. (h) A material adverse change occurs in Borrower's financial condition, or Lender believes the prospect of payment or performance of the Indebtedness is impaired. (i) Lender in good faith deems itself insecure.

LENDER'S RIGHTS. Upon default, Lender may declare the entire unpaid principal balance on this Note and all accrued unpaid interest immediately due, without notice, and then Borrower will pay that amount. Upon default, including failure to pay upon final maturity, Lender, at its option, may also, if permitted under applicable law, increase the variable interest rate on this Note 3.000 percentage points. The interest rate will not exceed the maximum rate permitted by applicable law. Lender may hire or pay someone else to help collect this Note if Borrower does not pay. Borrower also will pay Lender that amount. This includes, subject to any limits under applicable law, Lender's reasonable attorneys' fees and Lender's legal expenses whether or not there is a lawsuit, including reasonable attorneys' fees and legal expenses for bankruptcy proceedings (including efforts to modify or vacate any automatic stay or injunction), appeals, and any anticipated post-judgment collection services. If not prohibited by applicable law, Borrower also will pay any court costs, in addition to all other sums provided by law. THIS NOTE HAS BEEN DELIVERED TO LENDER AND ACCEPTED BY LENDER IN THE STATE OF MICHIGAN. IF THERE IS A LAWSUIT, BORROWER AGREES UPON LENDER'S REQUEST TO SUBMIT TO THE

JURISDICTION OF THE COURTS OF WASHTENAW COUNTY, THE STATE OF MICHIGAN. LENDER AND BORROWER HEREBY WAIVE THE RIGHT TO ANY JURY TRIAL IN ANY ACTION, PROCEEDING, OR COUNTERCLAIM BROUGHT BY EITHER LENDER OR BORROWER AGAINST THE OTHER. THIS NOTE SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE LAWS OF THE STATE OF MICHIGAN.

LINE OF CREDIT. This Note evidences a revolving line of credit. Advances under this Note may be requested orally by Borrower or by an authorized person. Lender may, but need not, require that all oral requests be confirmed in writing. All communications, instructions, or directions by telephone or otherwise to Lender are to be directed to Lender's office shown above. Borrower agrees to be liable for all sums either: (a) advanced in accordance with the instructions of an authorized person or (b) credited to any of Borrower's accounts with Lender. The unpaid principal balance owing on this

Note at any time may be evidenced by endorsements on this Note or by Lender's internal records, including daily computer print-outs. Lender will have no obligation to advance funds under this Note if: (a) Borrower or any guarantor is in default under the terms of this Note or any agreement that Borrower or any guarantor has with Lender, including any agreement made in connection with the signing of this Note; (b) Borrower or any guarantor ceases doing business or is insolvent; (c) any guarantor seeks, claims or otherwise attempts to limit, modify or revoke such guarantor's guarantee of this Note or any other loan with Lender; (d) Borrower has applied funds provided pursuant to this Note for purposes other than those authorized by Lender; or (e) Lender in good faith deems itself insecure under this Note or any other agreement between Lender and Borrower.

PRIOR NOTE. This Note is a renewal of that Promissory Note from Borrower to Lender dated June 27, 1997 in the amount of $4,000,000.00.

GENERAL PROVISIONS. This Note is payable on demand. The inclusion of specific default provisions or rights of Lender shall not preclude Lender's right to declare payment of this Note on its demand. Lender may delay or forgo enforcing any of its rights or remedies under this Note without losing them. Borrower and any other person who signs, guarantees or endorses this Note, to the extent allowed by law, waive presentment, demand for payment, protest and notice of dishonor. Upon any change in the terms of this Note, and unless otherwise expressly stated in writing, no party who signs this Note, whether as maker, guarantor, accommodation maker or endorser, shall be released from liability. All such parties agree that Lender may renew or extend (repeatedly and for any length of time) this loan, or release any party or guarantor or collateral; or impair, fail to realize upon or perfect Lender's security interest in the collateral; and take any other action deemed necessary by Lender without the consent of or notice to anyone. All such parties also agree that Lender may modify this loan without the consent of or notice to anyone other than the party with whom the modification is made.

PRIOR TO SIGNING THIS NOTE, BORROWER READ AND UNDERSTOOD ALL THE PROVISIONS OF

THIS NOTE, INCLUDING THE VARIABLE INTEREST RATE PROVISIONS. BORROWER AGREES TO THE TERMS OF THE NOTE AND ACKNOWLEDGES RECEIPT OF A COMPLETED COPY OF THE NOTE.

BORROWER:

MECHANICAL DYNAMICS, INC.

BY: /s/ David Peralta

DAVID PERALTA, VICE PRESIDENT/CFO

EXHIBIT 10.1

FIFTH AMENDMENT TO EMPLOYMENT AGREEMENT

THIS FIFTH AMENDMENT, made as of the 1st day of March, 1999, by and between MECHANICAL DYNAMICS, INC., a Michigan corporation (the "Company"), having offices located at 2301 Commonwealth Blvd., Ann Arbor, Michigan 48105, and MICHAEL E. KORYBALSKI, of Ann Arbor, Michigan ("Employee"), for the purpose of amending that certain Employment Agreement between the Company and Employee dated as of April 1, 1994, and amended by agreements dated as of March 1, 1995, as of March 1, 1996, as of March 1, 1997, and as of March 1, 1998 (collectively, the "Employment Agreement").

WITNESSETH:

WHEREAS, the Company and Employee desire to extend the Employment Agreement and to confirm certain modifications to the terms of said Agreement herein.

NOW, THEREFORE, in consideration of the foregoing and of the mutual covenants contained herein and in the Employment Agreement, the parties hereto agree as follows:

A. Section 2 of the Employment Agreement is hereby amended to extend the term of said Agreement through March 31, 2002.

B. Section 6 of the Employment Agreement is hereby deleted in its entirety and there is substituted therefor a new Section 6 as follows:

> "6. CHANGE OF DUTIES; RELOCATION. In the event that during the term of this Agreement, the Company's Board of Directors chooses to change the Employee's title as Chairman and Chief Executive Officer of the Company and/or his duties hereunder, or directs Employee to relocate away from Ann Arbor, Michigan, then Employee shall be entitled to resign and to receive as severance compensation, his entire base salary, bonus (calculated as provided in Section 7.4 hereof), vacation and fringe benefits in the amounts and payable as provided herein for a period equal to the then remaining term of this Agreement. Further, if the remaining term of this Agreement is less than one (1) year from the date of Employee's resignation, then the term of this Agreement shall be automatically extended through a date one (1) year from the date of such resignation."

C. Section 7.4 of the Employment Agreement is hereby deleted in its entirety and there is substituted therefor a new Section 7.4 as follows:

"7.4 Change of Control. In the event of a change in control (as hereinafter defined) of the Company, then the term of this Agreement shall be automatically extended through a date three (3) years from the effective date of such change in

control. Further, if, after the effective date of the change in control, Employee resigns for any reason or is terminated with or without "Cause", then, in any such event, the Company shall (a) continue to pay Employee's base salary on a monthly basis and provide all fringe benefits, in each case as in effect at the date of Employee's resignation or termination, for a period (the "Contract Period") equal to the greater of the remaining term of this Agreement or one (1) year from the date of resignation or termination and (b) pay Employee a bonus for the Contract Period equal to the highest bonus paid to Employee during the last three (3) calendar years preceding his resignation or termination multiplied by the number of months from the beginning of the calendar year in which resignation or termination occurs to the end of the Contract Period divided by twelve (12), said bonus to be paid in equal monthly installments during the Contract Period. Such payment and benefits shall be in lieu of all other payments and benefits to which Employee might otherwise be entitled under the Company's employee policies and procedures and/or under this Agreement. For purposes of this Section 7.4, the term "change of control" shall mean the sale of fifty percent (50%) or more of (i) the Company's outstanding capital stock or (ii) the assets of the Company."

D. Except as expressly modified herein, the Employment Agreement shall remain in full force and effect in accordance with its terms.

IN WITNESS WHEREOF, the parties hereto have duly executed this Fifth Amendment as of the day and year first above written.

WITNESS: COMPANY

MECHANICAL DYNAMICS, INC.

/s/ Linda K. Moore
____

/s/ Robert R. Ryan
By:__________________________________
Robert R. Ryan, President

EMPLOYEE

/s/ Linda K. Moore

/s/ Michael E. Korybalski

Michael E. Korybalski

EXHIBIT 10.2

FIFTH AMENDMENT TO EMPLOYMENT AGREEMENT

THIS FIFTH AMENDMENT, made as of the 1st day of March, 1999, by and between MECHANICAL DYNAMICS, INC., a Michigan corporation (the "Company"), having offices located at 2301 Commonwealth Blvd., Ann Arbor, Michigan 48105, and ROBERT R. RYAN, of Brighton, Michigan ("Employee"), for the purpose of amending that certain Employment Agreement between the Company and Employee dated as of April 1, 1994, and amended by agreements dated as of March 1, 1995, as of March 1, 1996, as of March 1, 1997, and as of March 1, 1998 (collectively, the "Employment Agreement").

WITNESSETH:

WHEREAS, the Company and Employee desire to extend the Employment Agreement and to confirm modifications to the terms of said Agreement herein.

NOW, THEREFORE, in consideration of the foregoing and of the mutual covenants contained herein and in the Employment Agreement, the parties hereto agree as follows:

A. Section 2 of the Employment Agreement is hereby amended to extend the term of said Agreement through March 31, 2001.

B. Section 6 of the Employment Agreement is hereby deleted in its entirety and there is substituted therefor a new Section 6 as follows:

> "6. CHANGE OF DUTIES; RELOCATION. In the event that during the term of this Agreement, the Company's Board of Directors chooses to change the Employee's title as President and Chief Operating Officer of the Company and/or his duties hereunder, or directs Employee to relocate away from Ann Arbor, Michigan, then Employee shall be entitled to resign and to receive as severance compensation, his entire base salary, bonus (calculated as provided in Section 7.4 hereof), vacation and fringe benefits in the amounts and payable as provided herein for a period equal to the then remaining term of this Agreement. Further, if the remaining term of this Agreement is less than one (1) year from the date of Employee's resignation, then the term of this Agreement shall be automatically extended through a date one (1) year from the date of such resignation."

C. Section 7.4 of the Employment Agreement is hereby deleted in its entirety and there is substituted therefor a new Section 7.4 as follows:

"7.4 Change of Control. In the event of a change in control (as hereinafter defined) of the Company, then the term of this Agreement shall be automatically extended through a date two (2) years from the effective date of such change in

control. Further, if, after the effective date of the change in control, Employee resigns for any reason or is terminated with or without "Cause", then, in any such event, the Company shall (a) continue to pay Employee's base salary on a monthly basis and provide all fringe benefits, in each case as in effect at the date of Employee's resignation or termination, for a period (the "Contract Period") equal to the greater of the remaining term of this Agreement or one (1) year from the date of resignation or termination and (b) pay Employee a bonus for the Contract Period equal to the highest bonus paid to Employee during the last three (3) calendar years preceding his resignation or termination multiplied by the number of months from the beginning of the calendar year in which resignation or termination occurs to the end of the Contract Period divided by twelve (12), said bonus to be paid in equal monthly installments during the Contract Period. Such payment and benefits shall be in lieu of all other payments and benefits to which Employee might otherwise be entitled under the Company's employee policies and procedures and/or under this Agreement. For purposes of this Section 7.4, the term "change of control" shall mean the sale of fifty percent (50%) or more of (i) the Company's outstanding capital stock or (ii) the assets of the Company."

D. Except as expressly modified herein, the Employment Agreement shall remain in full force and effect in accordance with its terms.

IN WITNESS WHEREOF, the parties hereto have duly executed this Fifth Amendment as of the day and year first above written.

WITNESS: COMPANY

MECHANICAL DYNAMICS, INC.

/s/ Linda K. Moore By: /s/ Michael E. Korybalski

_________________________ _________________________________

Michael E. Korybalski, CEO

EMPLOYEE

/s/ Linda K. Moore	/s/ Robert R. Ryan
___________________________	_______________________________________
	Robert R. Ryan

EXHIBIT 10.3

EMPLOYMENT AGREEMENT

THIS AGREEMENT, made as of the 1st day of March, 1997, by and between MECHANICAL DYNAMICS, INC., a Michigan corporation (the "Company"), having offices located at 2301 Commonwealth Blvd., Ann Arbor, Michigan 48105, and DAVID PERALTA, of Ann Arbor, Michigan ("Employee").

WITNESSETH:

WHEREAS, the Company desires to employ the Employee to devote his full time and attention to the business of the Company and Employee desires to be so employed.

NOW, THEREFORE, in consideration of the foregoing and of the mutual covenants herein contained, the parties hereto agree as follows:

1. EMPLOYMENT. The Company hereby agrees to employ Employee in the capacity of Vice President and Treasurer of the Company. Employee hereby accepts this employment and agrees to diligently and conscientiously devote his full and exclusive time and attention to the affairs of the Company. In his capacity as Vice President and Treasurer of the Company, Employee shall perform such duties of an executive nature as shall be assigned to him from time to time by the President, the Executive Vice

President or the Board of Directors and Employee shall at all times discharge his duties in consultation with and under the supervision of the President, the Executive Vice President and the Board of Directors.

2. TERM. The term of this Agreement shall commence on the date hereof and shall terminate on March 31, 1998. At the option of the Company, this Agreement may be extended for an additional one (1) year term, upon such terms as may be mutually agreed between Employee and the Company.

3. COMPENSATION. Employee's compensation hereunder, including base salary, bonus, vacation and other fringe benefits, for the term of this Agreement are set forth in Attachment I annexed hereto. The Company and Employee agree that during the term of this Agreement the fringe benefits offered to Employee shall be equal to the other Vice Presidents and shall include life insurance in an amount not less than twice Employee's base salary, if available.

4. DISABILITY. In the event that Employee is absent from his employment by reason of illness or other incapacity for a period of six (6) consecutive months, Employee shall nevertheless be entitled to receive his full base salary hereunder as well as his pro-rata bonus, vacation accruals and all fringe benefits during said six (6) month period. Thereafter, during the continued period of his illness or incapacity in excess of six (6) months, Employee shall be entitled to receive such long-term disability benefits as are payable under the Company's then long-term disability insurance program. He shall also receive continued health and life insurance benefits for the remaining

term of this Agreement. Except as provided above, all bonus accruals, vacation accruals and other fringe benefits shall cease at the end of said six (6) month period. Notwithstanding the foregoing, Employee's salary, bonus, vacation and other fringe benefits shall be fully reinstated upon his complete return to employment and the full discharge of his duties hereunder.

5. DEATH. In the event that Employee dies during the term of this Agreement while still employed hereunder and drawing his full base salary, then the Company shall continue to pay an amount equal to one hundred percent (100%) of Employee's monthly base salary (as of the date of his death) to his estate for a period of two (2) months subsequent to the date of his death. Such payments shall be in addition to any other death benefits payable to Employee's estate from life insurance or otherwise.

6. CHANGE OF DUTIES; RELOCATION. In the event that during the term of this Agreement the Board of Directors chooses to change the Employee's title as an officer of the Company and/or his duties hereunder, this Agreement shall nevertheless remain in full force and effect in accordance with its terms and no such change shall constitute grounds upon which Employee may terminate this Agreement. In the event that the Board of Directors directs Employee to relocate away from Ann Arbor, Michigan, then Employee shall be entitled to resign and to receive as severance compensation, the base salary and fringe

benefits provided in Section 7.1 hereof.

7. TERMINATION.

7.1 Without Cause. In the event Employee is discharged from his employment during the term of this Agreement without "Cause" (as hereinafter defined), then the Company shall continue to pay Employee's base salary and provide all fringe benefits and pro rata bonus, if applicable, in each case as in effect at the date of Employee's termination, for a period equal to the greater of six (6) months from the date of termination or the remaining term of this Agreement. Such payment and benefits shall be in lieu of all other payments and benefits to which Employee might otherwise be entitled under the Company's employee policies and procedures and/or under this Agreement.

7.2 For Cause; Resignation; Retirement. In the event that Employee is discharged from his employment during the term of this Agreement for "Cause" (as hereinafter defined), or Employee voluntarily resigns or retires, then Employee shall be entitled to receive only such payments and/or benefits as would be provided to other employees of the Company under similar circumstances in accordance with the Company's employee policies and procedures then in effect.

7.3 Definition. For purposes of this Agreement, the term "Cause" shall mean:

(i) Failure or refusal of Employee to work; or

(ii) Violation of directives of the Board of Directors or President by Employee; or

(iii) Intentional misrepresentation to or concealment of a material fact regarding the operations of the Company from the Board of Directors, the

President, or the Executive Vice President by Employee; or

(iv) A material breach of this Agreement by Employee; or

(v) Conviction of a crime involving moral turpitude. Except in the case of (v) above, termination of this Agreement for "Cause" shall only become effective thirty (30) days after Employee has received written notice of such termination from the Company specifying the details of such "Cause". During such thirty (30) day period, Employee shall be entitled to a formal meeting with the Board of Directors for the purpose of presenting reasons why the Agreement should not be terminated.

7.4 Change of Control. In the event that more than fifty percent (50%) of the issued and outstanding capital stock of the Company is purchased by any entity, person or group of persons acting in concert, and if the remaining term of this Agreement is less than one (1) year from the effective date of such change of control, then the term of this Agreement shall be automatically extended through a date one (1) year from such

effective date.

7.5 Release. Anything contained in this Section 7 to the contrary notwithstanding, the payment of any sums to Employee under subsections 7.1, 7.2 or 7.4 hereof, shall be conditioned upon (i) Employee executing and delivering to the Company the Full And Final Release attached hereto as Attachment II (the "Release") and (ii) in the event Employee is over forty (40) years of age on the date of execution of the Release, upon Employee not exercising his right to revoke said Release after having executed it.

8. RESTRICTIVE COVENANT. Employee agrees that during the term of this Agreement and for a period of two (2) years after the termination or expiration of this Agreement, he will not directly or indirectly, for his own benefit, or for or with any other person, firm, or corporation (a) own, manage, engage in,

be employed by, or consult for, any business in the United States which competes directly with the business presently conducted by the Company, or (b) encourage, solicit, attempt to hire as an employee or consultant or otherwise attempt to persuade any other employee of the Company to leave the employ of the Company. For purposes of this Agreement, the "business presently conducted by the Company" shall mean the development, manufacture, marketing or licensing of computer programs or software for mechanical systems simulation (often referred to as "multi-body system

analysis"). Employee further agrees that the Company's remedy at law for any breach of this restrictive covenant is inadequate and that the Company shall be entitled to injunctive relief with respect to any breach of this covenant.

9. NOTICE. Any notice to be delivered under this Agreement shall be given in writing and delivered, personally or by certified mail, postage prepaid, addressed to the Company or Employee at their last known addresses.

10. ENTIRE AGREEMENT. This Agreement constitutes the entire understanding of the parties hereto regarding the subject matter hereof, and there are no other agreements, conditions or representations, oral or written, express or implied, with regard thereto. This Agreement may be amended only in writing, signed by both parties.

11. BINDING EFFECT. The provisions of this Agreement shall be binding upon and shall inure to the benefit of both of the parties hereto and their respective successors and assigns.

12. GOVERNING LAW. This Agreement shall be governed by and construed under in accordance with the laws of the State of Michigan.

IN WITNESS WHEREOF, the parties hereto have duly executed this Agreement as of the day and date first above written.

WITNESS: COMPANY

MECHANICAL DYNAMICS, INC.

/s/ Linda K. Moore By: /s/ Robert R. Ryan, President
------------------------------ --
Robert R. Ryan, President

EMPLOYEE

/s/ Linda K. Moore /s/ David Peralta
------------------------------ --
David Peralta

COMPENSATION COMMITTEE REPORT

ATTACHMENT I

1997 COMPENSATION
DAVID PERALTA
VICE PRESIDENT FINANCE
CHIEF FINANCIAL OFFICER

==

Base Salary:	$90,000
Car allowance:	$3,600/year
Life Insurance:	$200,000
Bonus:	20% of Base at plan
Plan:	25% revenue growth
	$.50 Earnings per share
Options:	10,000, four year vesting period
Employment agreement:	Contract expiring 3/31/98

Under this plan you are ineligible for MDI's company profit sharing plan

The bonus matrix is as follows:

<TABLE>
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GROWTH	EARNINGS PER SHARE				
	<$0.40	$0.40	$0.50	$0.60	$0.70
<15%	$0	$0	$0	$0	$0
20%	$0	$4,500	$9,000	$13,500	$18,000
25%	$0	$9,000	$18,000	$27,000	$36,000
30%	$0	$13,500	$27,000	$40,500	$54,000
35%	$0	$18,000	$36,000	$54,000	$72,000

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- Revenue growth between 0% and 35% will be linearly interpolated. Revenue growth beyond 35% will linearly extrapolated.

- Earnings per Share between $.40 and $.70 will be linearly interpolated. Earnings per Share beyond $.70 will be limited to $.70

11

ATTACHMENT II

FULL AND FINAL RELEASE

In consideration of the termination benefits provided to me by MECHANICAL DYNAMICS, INC., a Michigan corporation ("MDI"), as set out in Section

7 of the attached Employment Agreement, as amended (Attachment A), I hereby agree as follows:

1. MECHANICAL DYNAMICS, INC. When used herein, "MDI" includes any parent, subsidiary, associated and affiliated companies of Mechanical Dynamics, Inc., and its and their successors, assigns, officers, directors, agents, employees and attorneys, past, present or future, jointly and individually.

2. RELEASE OF CLAIMS. I release and forever discharge MDI, from any and all claims, disputes, causes of action, administrative proceedings, legal actions, whether arising out of statutory law, common law or equity, and damages, known or unknown, which I have or may have against MDI, however denominated, including, but not limited to, claims related to my employment, the conduct of MDI during my employment, any claims of discrimination under any federal, state or local law, rule or regulation (including claims under the Age Discrimination in Employment Act (ADEA)), any claims under ERISA, any claim for violation of any other federal, state or local law, rule or regulation, any claim for wrongful termination of employment, wrongful layoff, failure to recall to work, breach of contract, violation of any policy, practice or procedure of MDI, denial of any employment benefit, constructive discharge, retaliatory discharge, breach of the covenant of good faith and fair dealing, detrimental reliance, termination in violation of public policy, violation of any whistleblower statute, negligent supervision, negligent conducting of performance appraisals, libel, slander, defamation, fraud, misrepresentation, sexual or any other type of harassment, intentional or negligent infliction of emotional distress, tortious interference with business relations or prospective employers, providing false references, any claim to reinstatement or future employment, any claim for damages, attorney fees or costs and any claims occurring or existing through the date of this Release. I understand and agree that I waived my right in the preceding sentence to file a lawsuit or to commence an administrative action against MDI. If I later file a lawsuit or administrative action, I shall be liable for the actual attorney fees and costs incurred by MDI in defending any such legal action.

3. SCOPE OF RELEASE. This Release covers all issues arising from or in connection with my employment with MDI as well as any issues, disputes or claims occurring or existing through the date of this Release.

4. PRIOR CLAIMS. I have not filed any claim, administrative proceeding or legal action against MDI.

5. SUBSEQUENT LEGAL ACTION. I will not initiate, assist or cooperate in any charge, claim, complaint or legal action against MDI with any federal, state or local administrative agency or court, or with any other person (the term "person" shall mean and include an individual, a partnership, a joint venture, a corporation, a limited liability, a trust, an unincorporated organization, and a government or any department or agency thereof), unless so ordered by a duly

authorized court, legislative committee or grand jury.

6. DEROGATORY COMMENTS. I shall not make any negative or derogatory statements of any kind about MDI, MDI's products and services, or MDI's employee's, past, present or future.

7. RESIGNATION AS OFFICER. Effective with the date of my separation from employment with MDI, I resign any corporate office I hold.

8. RETURN OF PROPERTY. I have returned all MDI property as defined in and required by the Confidentiality Agreement signed by me in favor of MDI (hereinafter the "Confidentiality Agreement").

9. INJUNCTIVE RELIEF. In the event of a breach or threatened breach by me of this Release, it is agreed that money damages would not adequately compensate MDI and that injunctive relief would be essential for its protection. Such relief shall be without prejudice to any other remedy which MDI may have or be entitled to receive at law or in equity.

10. NON-ADMISSION. Nothing contained herein shall be construed as an admission of liability by MDI in connection with my employment with and separation from MDI as well as through the date of this Release.

11. FINALITY OF RELEASE. I recognize that I may be mistaken as to the facts and/or law upon which I may be relying in executing this Release or that additional facts may exist of which I am not presently aware. Nonetheless, I have been fully advised and understand the finality of this Release and intend to be bound by it.

12. REVIEW OF DOCUMENT. I have had the opportunity to read and discuss this Release with MDI, and I have had an opportunity to review this Release with outside legal counsel.

13. REVIEW AND REVOCATION PERIODS. I have been given twenty-one (21) days within which to consider this Release before executing it, I have been advised that I may revoke this Release for a period of seven (7) calendar days following the execution of

this Release and that the Release is not effective until the revocation period has expired and I have notified MDI in writing that I did not revoke the Release. Notice of revocation and/or non-revocation should be provided in writing by me to MDI at 2301 Commonwealth Blvd., Ann Arbor, Michigan 48105, Attn: Michael E. Korybalski, CEO.

Section 13 is applicable only if the undersigned is 40 years of age or older on date of termination.

14. AUTHORITY TO RELEASE. I have the authority to release the claims which are released herein and no claims have been previously assigned to or are owned by any other person or entity.

15. ENTIRE AGREEMENT. No other written or oral promises, inducements or agreements have been made by MDI to me. I understand that this Release may not be modified, altered or changed in any respect except upon the express prior written consent by me and MDI.

16. SEVERABILITY. If after the date of execution of this Release, any provision of this Release is held to be illegal, invalid, or unenforceable, such provision shall be fully severable. In lieu thereof, there shall be added a provision as similar in terms to such illegal, invalid or unenforceable provision as may be possible and be legal, valid and enforceable.

17. GOVERNING LAW. This Release shall be construed in accordance with and shall be governed by the laws of the State of Michigan.

18. HEADINGS. All headings in this Release are inserted for convenience of reference only and shall not be deemed to affect the meaning or interpretation of this Release.

19. USAGE. Wherever applicable, the masculine gender, when used herein shall include the feminine gender, and the singular shall include the plural.

IN WITNESS WHEREOF, I have executed this Release as of the date noted below.

/s/ Linda K. Moore	/s/ David Peralta
Witness	[name]
DATE: 6-23-97	DATE: 6-23-97

FIRST AMENDMENT TO EMPLOYMENT AGREEMENT

THIS FIRST AMENDMENT, made as of the 1st day of March, 1998, by and between MECHANICAL DYNAMICS, INC., a Michigan corporation (the "Company"), having offices located at 2301 Commonwealth Blvd., Ann Arbor, Michigan 48105, and DAVID PERALTA, of Livonia, Michigan ("Employee"), for the purpose of amending that certain Employment Agreement between the Company and Employee dated as of March 1, 1997 (the "Employment Agreement").

WITNESSETH:

WHEREAS, the Company and Employee desire to extend the Employment Agreement and to confirm the same herein.

NOW, THEREFORE, in consideration of the foregoing and of the mutual covenants contained herein and in the Employment Agreement, the parties hereto agree as follows:

A. Section 2 of the Employment Agreement is hereby amended to extend the term of said Agreement through March 31, 1999.

B. Except as expressly modified herein, the Employment Agreement shall remain in full force and effect in accordance with its original terms.

IN WITNESS WHEREOF, the parties hereto have duly executed this First Amendment as of the day and date first above written.

WITNESS:	COMPANY
	MECHANICAL DYNAMICS, INC.
/s/ Linda Moore	By: /s/ Robert R. Ryan, President
------------------------------	Robert R. Ryan, President
	EMPLOYEE
/s/ Linda Moore	/s/ David Peralta
------------------------------	David Peralta

SECOND AMENDMENT TO EMPLOYMENT AGREEMENT

THIS SECOND AMENDMENT, made as of the 1st day of March, 1999, by and between MECHANICAL DYNAMICS, INC., a Michigan corporation (the "Company"), having offices located at 2301 Commonwealth Blvd., Ann Arbor, Michigan 48105, and DAVID PERALTA, of Livonia, Michigan ("Employee"), for the purpose of amending that certain Employment Agreement between the Company and Employee dated as of March 1, 1997, and amended by agreement dated as of March 1, 1998 (collectively, the "Employment Agreement").

WITNESSETH:

WHEREAS, the Company and Employee desire to extend the Employment Agreement and to confirm a modification of said Agreement herein.

NOW, THEREFORE, in consideration of the foregoing and of the mutual covenants contained herein and in the Employment Agreement, the parties hereto agree as follows:

A. Section 2 of the Employment Agreement is hereby amended to extend the term of said Agreement through March 31, 2000.

B. Section 7.4 of the Employment Agreement is hereby deleted in its entirety and there is substituted therefor a new Section 7.4 as follows:

> "7.4 Change of Control. In the event of a change in control (as hereinafter defined) of the Company, if the remaining term of this Agreement is less than one (1) year from the effective date of such change of control, then the term of this Agreement shall be automatically extended through a date one (1) year from such effective date. For purposes of this Section 7.4, the term "change of control" shall mean the sale of fifty percent (50%) or more of (i) the Company's outstanding capital stock or (ii) the assets of the Company."

C. Except as expressly modified herein, the Employment Agreement shall remain in full force and effect in accordance with its terms.

IN WITNESS WHEREOF, the parties hereto have duly executed this Second Amendment as of the day and year first above written.

WITNESS: COMPANY

MECHANICAL DYNAMICS, INC.

/s/ Linda K. Moore

____

By: /s/ Robert R. Ryan

____

Robert R. Ryan, President

EMPLOYEE

/s/ Linda K. Moore

/s/ David Peralta

David Peralta

EXHIBIT 11

MECHANICAL DYNAMICS, INC. AND SUBSIDIARIES

STATEMENT RE COMPUTATION OF PER SHARE EARNINGS
FOR THE YEARS ENDED DECEMBER 31, 1998, 1997 AND 1996

in thousands, except share and per share data	1998	1997	1996
BASIC EARNINGS PER SHARE:			
Net income (loss)	$ (217)	$ 744	$ 2,071
Weighted average common shares outstanding	6,186,469	5,805,936	4,990,215
Basic net income (loss) per common share	$ (0.04)	$ 0.13	$ 0.42
DILUTED EARNINGS PER SHARE:			
Net income (loss)	$ (217)	$ 744	$ 2,071
Weighted average common shares outstanding	6,186,469	5,805,936	4,990,215
Effect of stock options and warrants	--	61,817	79,813
Weighted average common and common equivalent shares outstanding	6,186,469	5,867,753	5,070,028
Diluted net income (loss) per common share	$ (0.04)	$ 0.13	$ 0.41

EXHIBIT 21

MECHANICAL DYNAMICS, INC. AND SUBSIDIARIES

SUBSIDIARIES OF THE REGISTRANT

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Mechanical Dynamics, Inc.	Michigan, USA	
MDI International, Inc.	Michigan, USA	100% owned by Mechanical Dynamics, Inc.
Mechanical Dynamics Ltd.	Canada	100% owned by Mechanical Dynamics, Inc.
Mechanical Dynamics FSC, Inc.	Barbados	100% owned by Mechanical Dynamics, Inc.
Mechanical Dynamics GmbH	Germany	100% owned by Mechanical Dynamics, Inc.
Mechanical Dynamics SarL	France	100% owned by Mechanical Dynamics, Inc.
Mechanical Dynamics International, Ltd.	United Kingdom	100% owned by Mechanical Dynamics, Inc.
Mechanical Dynamics Sweden AB	Sweden	100% owned by Mechanical Dynamics, Inc.
Mechanical Dynamics Italy srl	Italy	100% owned by Mechanical Dynamics, Inc.
DTI Asia Pte. Ltd.	Singapore	100% owned by Mechanical Dynamics, Inc.
MEC.Design srl	Italy	99% owned by Mechanical Dynamics Italy srl
Mechanical Dynamics Japan K.K.	Japan	66% owned by Mechanical Dynamics, Inc.

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EXHIBIT 23.1

MECHANICAL DYNAMICS, INC. AND SUBSIDIARIES

CONSENT OF INDEPENDENT PUBLIC ACCOUNTANTS

As independent public accountants, we hereby consent to the incorporation of our reports included in this Form 10-K, into the Company's previously filed Registration Statement File No. 333-17957.

ARTHUR ANDERSEN LLP

March 26, 1999,
Detroit, Michigan.

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