EVOLVE SOFTWARE INC
Form 10-Q
May 14, 2002

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2002
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: 000-31155

EVOLVE SOFTWARE, INC.
(Exact name of registrant as specified in its charter)

DELAWARE	94-3219745
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1400 65TH STREET, SUITE 100, EMERYVILLE, CA	94608
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (510) 428-6000

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

Securities registered pursuant to Section 12(g) of the Act: Common Stock, $0.001 par value

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

The aggregate market value of the voting common stock held by non-affiliates of the registrant as of May 13, 2002 was approximately $7,264,316 based upon the closing sale price reported for that date on the NASDAQ National Market. Shares of common stock held by each officer and director and by each person who owns more than 5% or more of the outstanding common stock have been excluded because such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily conclusive for other purposes.

The number of shares outstanding of the registrant's common stock as of May

13, 2002 was 44,836,414.

EVOLVE SOFTWARE, INC.

FORM 10-Q

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

EVOLVE SOFTWARE, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS)

ASSETS

Current assets:
Cash and cash equivalents. . . . .
Short-term investments
Accounts receivable, net of allowance for doubtful
Accounts $455 and $730, respectively. . . . .
Prepaid expenses and other current assets. . . . .
Notes receivable from related party. . . . .

Total current assets. . . . .

Restricted cash. . . . .
Property and equipment, net. . . . .
Deposits and other assets. . . . .
Goodwill and other intangible assets, net. . . . .

Total assets . . . .

LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND PREFERRED STOCK WARRANTS,
AND STOCKHOLDERS' EQUITY
Current liabilities:
Accounts payable . . . .
Accrued liabilities. . . . .
Deferred revenues. . . . .
Capital lease obligations, current portion . . . .
Restructuring accrual, current portion . . . .
Short-term debt. . . . .

Total current liabilities. . . . .

Capital lease obligations, less current portion. . . . .
Restructuring accrual, less current portion. . . . .
Long-term debt . . . .
Deferred rent. . . . .
Common stock warrants. . . . .

Total liabilities. . . . .

Redeemable convertible preferred stock and preferred stock warrants. . . . .

Stockholders' equity:
Preferred stock. . . . .
Common stock . . . .
Additional paid-in capital . . . .
Notes receivable from stockholders . . . .
Unearned stock-based compensation. . . . .
Accumulated other comprehensive income . . . .
Accumulated deficit. . . . .

Total stockholders' equity. . . . .

Total liabilities, redeemable convertible preferred stock and preferred stock warrants,
and stockholders' equity. . . . .

The accompanying notes are an integral part of these condensed consolidated financial

EVOLVE SOFTWARE, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	THREE MONTHS ENDED MARCH 31,	
	2002	2001
	(unaudited)	
Revenues:		
Solutions	$ 1,994	$ 8,84
Subscriptions	1,470	2,41
Total revenues.	3,464	11,26
Cost of revenues:		
Solutions	879	3,34
Subscriptions	286	1,24
Stock-based and related compensation charges.	138	39
Total cost of revenues.	1,303	4,98
Gross profit.	2,161	6,27
Operating expenses:		
Sales and marketing:		
Other sales and marketing	3,259	10,44
Stock-based and related compensation charges.	547	57
Research and development:		
Other research and development.	2,769	6,97
Stock-based and related compensation charges.	(463)	67
General and administrative:		
Other general and administrative.	1,753	3,08
Stock-based and related compensation charges.	1,897	2,22
Amortization of goodwill and other intangible assets.	359	2,66
Restructuring charges, net.	(21)	
Total operating expenses.	10,100	26,62
Operating loss.	(7,939)	(20,34

Other income, net	1,593	44
Net loss	(6,346)	(19,90
Beneficial conversion feature of preferred stock	(212)	
Net loss attributable to common stockholders	$ (6,558)	$ (19,90
Net loss per common share -- basic and diluted	$ (0.15)	$ (0.5
Shares used in net loss per common share calculation -- basic and diluted	43,715	33,97

The accompanying notes are an integral part of these condensed consolidated financial s

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EVOLVE SOFTWARE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)

	NINE MONTHS EN
	2002
	(unaudi
Cash flows from operating activities:	
Net loss	$ (34,372) $
Adjustments to reconcile net loss to net cash used in operating activities:	
Loss on disposal of fixed assets	-
Allowance for doubtful accounts	885
Depreciation and amortization - fixed assets	2,730
Amortization of goodwill and other intangible assets	1,161
Non-cash restructuring charges	1,132
Write-down of stockholders' loans and related interest	7,120
Accrued interest	-
Stock-based charges	4,032
Revaluation of common stock warrants	15
Changes in assets and liabilities:	
Accounts receivable	2,976
Prepaid expenses and other current assets	195
Deposits and other assets	480
Accounts payable	(2,240)
Accrued liabilities	(2,259)
Restructuring accrual	(4,150)
Deferred revenues	(991)
NET CASH USED IN OPERATING ACTIVITIES	(23,286)

Cash flows from investing activities:	
Purchases of short-term investments	(532)
Maturities of short-term investments	3,373
Purchases of property and equipment	(192)
Proceeds from sale of property and equipment	-
Purchases of intangibles	-
Restricted cash	(2,901)
NET CASH USED IN INVESTING ACTIVITIES	(252)
Cash flows from financing activities:	
Payments under capital lease obligations	(476)
Payments of long-term debt	(1,584)
Proceeds from initial public offering	-
Proceeds from issuance of preferred stock, net of issuance costs	17,899
Proceeds from exercise of common stock options	-
Proceeds from exercise of common stock warrants	-
Proceeds from issuance of debt	-
Proceeds from payment on note receivable	-
Proceeds from employee stock purchase plan	101
Payments on repurchase of common stock	(13)
NET CASH PROVIDED BY FINANCING ACTIVITIES	15,927
Effect of exchange rate changes on cash and cash equivalents	(76)
Increase (decrease) in cash and cash equivalents	(7,687)
Cash and cash equivalents at beginning of period	19,914
Cash and cash equivalents at end of period	$ 12,227

The accompanying notes are an integral part of these condensed consolidated financial state

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EVOLVE SOFTWARE, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

THE COMPANY

Evolve Software, Inc. (the "Company" or "Evolve") was incorporated under the laws of the state of Delaware in February 1995 for the purpose of designing, developing, marketing and supporting enterprise application software products. The accompanying condensed consolidated financial statements include the accounts of Evolve Software, Inc. and the Company's wholly-owned subsidiaries, Evolve Software Europe Ltd., Evolve Software (India) Pvt. Ltd. and Evolve Canada, Inc., which were incorporated in May 2000, December 2000 and April 2001, respectively.

LIQUIDITY

The Company has sustained net losses and negative cash flows from operations since its inception. The Company's ability to fund its obligations in the ordinary course of business is dependent on its ability to increase revenues, to manage net operating expenses and to raise additional financing through public

or private equity financing or other sources of financing. There is no assurance that the Company will achieve a sufficient increase in revenues or maintain a reduction of net operating expenses or that it will be able to raise adequate financing from other sources.

BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. All adjustments (including adjustments of a normal recurring nature) considered necessary for a fair presentation have been included. Operating results for the three- and nine-month periods ended March 31, 2002, are not necessarily indicative of the results that may be expected for the year ending June 30, 2002. For further information, refer to the financial statements and notes thereto included in the Company's Annual Report on Form 10K/A.

PRINCIPLES OF CONSOLIDATION

The condensed consolidated financial statements include the accounts of Evolve and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

USE OF ESTIMATES

The Company has prepared these financial statements in conformity with generally accepted accounting principles which require it to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

REVENUE RECOGNITION

The Company derives revenues from fees for licenses and implementation services ("Solutions revenue") and fees from maintenance, application service provider ("ASP") and subscription agreements ("Subscriptions revenue"). The Company recognizes revenues in accordance with the provisions of American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, "Software Revenue Recognition." The Company also follows the provisions of the Securities Exchange Commission's Staff Accounting Bulletin No. 101 (SAB 101), "Revenue Recognition in Financial Statements."

Under SOP 97-2 as amended, the Company recognizes revenues when all of the following conditions are met:

- when persuasive evidence of a customer agreement exists;
- the delivery of the product or service subject to the agreement has occurred;
- the associated fees are fixed or determinable; and
- the Company believes that collection of these fees is reasonably assured.

The Company's customer agreements typically include arrangements for maintenance services to be provided by the Company. Generally, the Company has vendor specific objective evidence of fair value for the maintenance element of

software arrangements based on the renewal rates for maintenance in future years as specified in the contracts. In those cases where first year maintenance revenue is included in the license fee, the Company defers the fair value of the first year maintenance revenue at the outset of the arrangement and recognizes it ratably over the period during which the maintenance is to be provided, which normally commences on the date the software is delivered.

The Company has established vendor specific objective evidence of fair value for certain services. For these contracts, which involve significant implementation or other services which are essential to the functionality of the software and which are reasonably estimable, the license and services revenue is recognized over the period of each implementation, primarily using the percentage-of-completion method. Labor hours incurred are used as the measure of progress towards completion. Revenue for these arrangements is classified as Solutions revenue. A provision for estimated losses on engagements is made in the period in which the loss becomes probable and can be reasonably estimated. In cases where a sale of a license does not include implementation services (e.g., a sale of additional seats or a sale of product to be implemented by a third party), revenue is recorded upon delivery with an appropriate deferral for maintenance services, if applicable, provided all of the other relevant conditions have been met.

The Company generates revenue from its ASP business by hosting the software and making the solution available to the customer via the Internet, as well as by providing maintenance and other services to the customer. In such situations, customers pay a monthly fee for the term of the contract in return for access to the Company's software, maintenance and other services such as implementation, training, consulting and hosting. For certain ASP software arrangements for which the Company does not have vendor specific objective evidence of fair value for the elements of the contract, fees are recognized on a monthly basis as the hosting service is provided. In other circumstances where the customer has the right to take delivery of the software and the Company has vendor specific objective evidence of fair value for the hosting element of the contract, fees are allocated between the elements based on the vendor specific objective evidence. Revenue for these hosting arrangements is classified as Subscriptions revenue.

License revenue includes product licenses to companies from which the Company has purchased products and services under separate arrangements executed within a short period of time ("reciprocal arrangements"). Products and services purchased in reciprocal arrangements include: 1) software licensed for internal use; 2) software licensed for resale or incorporation into the Company's products; and 3) development or implementation services. For reciprocal arrangements, the Company considers Accounting Principles Board (APB No. 29), "Accounting for Nonmonetary Transactions," and Emerging Issues Task Force (EITF, Issue No. 86-29), "Nonmonetary Transactions: Magnitude of Boot and Exceptions to the Use of Fair Value, Interpretation of Accounting Principles Board No. 29, Accounting for Nonmonetary Transactions" to determine whether the arrangement is a monetary or nonmonetary transaction. In determining these fair values, the Company considers the recent history of cash sales of the same products or services in similar sized transactions. Revenues recognized under reciprocal arrangements were $258,000 and $204,000 for the fiscal quarters ended March 31, 2002 and 2001, respectively, and $862,000 and $1.3 million for the nine months ended March 31, 2002 and 2001, respectively.

Deferred revenue represents fees derived from maintenance, ASP and subscription agreements that are being recognized ratably over the unexpired portion of the underlying period of the agreements. Deferred revenue also represents amounts billed to customers under license and service arrangements in excess of amounts recognized as revenue to date from those arrangements. As work progresses towards completion of these arrangements, a portion of the deferred revenue will be recognized. Certain revenues will also be deferred, if other revenue

recognition criteria have not been met.

COMPREHENSIVE INCOME (LOSS)

The Company follows Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting Comprehensive Income." SFAS No. 130 establishes standards for reporting and display of comprehensive income (loss) and its components in financial statements. The statement of comprehensive loss is as follows (in thousands):

	THREE MONTHS ENDED MARCH 31,		NINE MONTHS ENDED MARCH 31,	
	2002	2001	2002	2001
Net loss	$ (6,346)	$ (19,902)	$ (34,372)	$ (67,542)
Unrealized loss on investments	-	(500)	-	(500)
Foreign currency translation adjustment	123	104	(12)	62
Comprehensive loss	$ (6,223)	$ (20,298)	$ (34,384)	$ (67,980)

SEGMENT INFORMATION

The Company operates in only one segment, namely workforce optimization software and, as such, uses only one measure of profitability for internal reporting purposes. To date, substantially all of the Company's revenues have been derived from within the United States. Additionally, substantially all of the Company's long-lived assets are located in the United States.

RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001, the Securities and Exchange Commission ("SEC") issued Staff Topic No. D-98, which provides clarification on the classification and measurement of redeemable equity securities. This announcement provides clarification about the balance sheet classification and measurement of securities subject to either mandatory redemption features or whose redemption is outside the control of the issuer. The Company has determined that, at issuance, the terms of the Series A Preferred Stock that was issued in October 2001, qualified for presentation outside of permanent equity, based on the guidance in Topic No. D-98. In March 2002, certain Series A Preferred stockholders agreed to waive the mandatory redemption feature and other rights and, accordingly, in March, the amended shares qualified for presentation as part of permanent equity.

In July 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires business combinations initiated after June 30, 2001, to be accounted for using the purchase method of accounting, and broadens the criteria for recording intangible assets separately from goodwill. Recorded goodwill and intangibles will be evaluated against these new criteria and may result in certain intangibles being subsumed into goodwill, or alternatively, amounts initially recorded as goodwill may be separately identified and recognized apart from goodwill. SFAS No. 142 requires the use of a non-amortization approach to account for purchased goodwill and certain intangibles. Under a non-amortization approach, goodwill and certain

intangibles will not be amortized into results of operations, but instead would be reviewed for impairment and written-down and charged to results of operations only in the periods in which the recorded value of goodwill and certain intangibles is more than its fair value. Evolve will continue to amortize goodwill and purchased intangible assets acquired prior to June 30, 2001, until it adopts SFAS No. 142. For business combinations initiated after June 30, 2001, Evolve will follow the non-amortization method under SFAS No. 142. Evolve is required to adopt the provisions of SFAS No. 142 on July 1, 2002. Evolve is currently assessing SFAS No. 142 and has not determined the impact on Evolve's condensed consolidated financial statements.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets to be held and used, to be disposed of other than by sale and to be disposed of by sale. Although SFAS No. 144 retains certain of the requirements of SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of," it supersedes SFAS No. 121 and APB Opinion No. 30, "Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions for the Disposal of a Segment of a Business." SFAS No. 144 also amends Accounting Research Bulletin No. 51, "Consolidated Financial Statements," to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. The statement is effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early adoption encouraged. The Company is currently assessing the impact of adopting SFAS No. 144 on the Company's financial position and results of operations.

NOTE 2. ACQUISITIONS

On June 29, 2001, Evolve acquired certain assets of Vivant! Corporation ("Vivant"). The total acquisition cost was approximately $3.1 million, primarily comprised of $910,000 in cash, 1,553,254 shares of the Company's common stock valued at $1.6 million, a future stock commitment valued at a minimum of $525,000 and $137,000 for transaction related expenses. With the assistance of an independent valuation, the Company recorded approximately $2.2 million in developed technology, $717,000 in goodwill and $187,000 in acquired workforce upon this acquisition, which was accounted for as a purchase. The number of shares issued to Vivant at the closing of the acquisition was subject to adjustment by issuance of additional shares or redemption of existing shares based on the market value of Evolve's common stock as of the time the registration of such shares became effective. As a result, the Company subsequently issued 663,495 shares to Vivant in September 2001 and 3,899,756 shares in January 2002 pursuant to the terms of the acquisition. The Company is still refining its purchase price allocation, which may result in adjustments in future periods. In addition, Evolve has agreed to issue to Vivant additional shares of its common stock with a value of up to $525,000 within ten days after the one-year anniversary of the closing of the acquisition (July 9, 2002) and additional shares with a value up to $3,900,000 at specified times based on receipts from the sale of Vivant's products for the shorter of twenty-four months from the date of the agreement or eighteen months from the Company's first customer contract that incorporates Vivant technology. However, the asset acquisition agreement governing the purchase of the Vivant assets limits the aggregate number of shares of common stock to be issued by the Company to not exceed 7,661,097 shares or 1,544,592 shares in excess of those issued through January 31, 2002. The results of Vivant's operations have been included in the Company's condensed consolidated financial statements since the date of acquisition.

The following unaudited pro forma consolidated financial information presents the combined results of Evolve and Vivant as if the acquisition had occurred on July 1, 2000, after giving effect to certain adjustments, principally the amortization of goodwill and other intangible assets. The unaudited pro forma consolidated financial information does not necessarily reflect the results of operations that would have occurred had the acquisition been completed on July 1, 2000 (in thousands, except per share amounts).

	NINE MONTHS ENDED MARCH 31, 2001
Pro forma total revenue	$ 27,477
Pro forma net loss	$ (76,007)
Basic and diluted pro forma net loss per share	$ (2.15)
Shares used to compute basic and diluted pro forma net loss per share	35,418

NOTE 3. STOCK-BASED AND RELATED COMPENSATION CHARGES

The Company incurred stock-based compensation charges in connection with stock option grants and sales of restricted stock to employees at exercise or sales prices below the deemed fair market value of its common stock for accounting purposes. The cumulative difference between the deemed fair value of the underlying stock at the date the options were granted and the exercise price of the granted options was $40.3 million as of August 9, 2000, the date of the Company's Initial Public Offering. This amount is being amortized, using the accelerated method of FASB Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable or Award Plans," over the four-year vesting period of the granted options. Based on the unearned stock-based compensation balance at March 31, 2002, the Company's results from operations will include stock-based compensation expense, at a minimum, through 2004. The Company recorded stock-based charges of $2.1 million and $11.2 million for the three- and nine- months ended March 31, 2002, respectively, and $3.9 million and $20.5 million for the three- and nine- months ended March 31, 2001, respectively. Future terminations or modifications to existing awards will impact future stock-based compensation expense.

In connection with the termination of employment of certain executive officers in fiscal 2001, the Company entered into arrangements with those executive officers to provide consulting services. For accounting purposes, this was deemed to be a change in status of the employee and resulted in a new measurement date for the amended equity awards in accordance with FIN No. 44, "Accounting for Certain Transactions Involving Stock Compensation." In addition, for other executive officers of Evolve whose employment was terminated in fiscal 2001 and who had purchased restricted stock with full recourse notes,

the Company agreed, as part of their termination settlements, to allow them to sell back to the Company their restricted shares in exchange for cancellation of the notes. Accordingly, these notes are accounted for as non-recourse notes on a variable basis such that the charge/credit arising from these notes will fluctuate from period to period based on the Company's stock price. The revaluation charge for the notes subject to remeasurement was not significant for the quarter ended March 31, 2002. The financial impact of these arrangements is included within stock-based compensation expense, which has been allocated to the appropriate functional categories within the Statement of Operations.

In October 2001, the Board of Directors voted to modify existing stockholder loans, which were issued to allow board members, officers and selected employees to exercise stock options and purchase restricted stock, from full-recourse to non-recourse and to extend their due dates, in the event of termination, from thirty days to fifteen months after the date of termination. The loans are secured only by the underlying stock, which they were used to purchase. As a result, the loans became subject to variable accounting and the outstanding stockholder loans and related interest were revalued to their net realizable value of $0.21 per share at March 28, 2002, resulting in charges of $710,000 and $7.1 million for the three- and nine- months ended March 31, 2002, respectively. Until they are due or repaid, if earlier, the loans will be revalued each quarter to their net realizable value as determined by the stock price at that time.

NOTE 4. LONG-TERM DEBT

On November 13, 2001, the Company revised an existing credit arrangement and signed an amended Loan and Security Agreement to restructure its excess credit facilities, to obtain a waiver of certain defaults under the previous credit arrangement and to reduce the line-of-credit to $2.9 million and the term loan credit facility to $4.4 million with interest accruing at the bank's prime rate plus 0.75% and 1.00%, respectively. At March 31, 2002, these rates were 5.50% and 5.75%, respectively. As of March 31, 2002, the Company had utilized $4.8 million of the term loan credit facility and had repaid $1.6 million. The loan will be fully repaid by July 1, 2003. Both the line-of-credit and the term loan credit facility are collateralized by all of the Company's assets, including intellectual property, except for previously leased equipment. In connection with the loan amendment the bank approved new financial covenants for the periods commencing October 1, 2001. Under these covenants, the Company is required to: (1) maintain at all times a minimum bank liquidity ratio of 1.50 to 1.00, reducing to a ratio of 1.25 to 1.00 on January 31, 2002, (the cash component of this ratio is required to be held at the bank); (2) beginning with the month ending December 31, 2001, maintain, on a monthly basis, the greater of (a) a minimum company liquidity ratio of 1.75 to 1.00 or (b) $14,000,000 in unrestricted cash (unrestricted cash will include any restricted cash held by the bank) reducing to $8,000,000 on January 31, 2002; (3) beginning with the month ending December 31, 2001, not exceed a leverage maximum of 2.25 to 1.00; and (4) meet a milestone covenant of obtaining at least $10,000,000 in new equity from investors acceptable to the bank by October 15, 2001.

The Company was in violation of the maximum leverage ratio financial covenant from December 2001 through February 2002. However, the Company received a waiver of all defaults in March 2002. On April 19, 2002, the Company signed a first amendment to the amended and restated Loan and Security Agreement, which amended certain financial covenants. In connection with the amendment, the bank approved new financial covenants commencing April 1, 2002. Under the new covenants, the Company is required to: (1) maintain, at all times, a minimum bank liquidity ratio of not less than 1.25 to 1.00; (2) maintain, at all times, unrestricted cash (unrestricted cash will include any restricted cash held by the bank) of not less then $8,000,000; and (3) maintain minimum revenue targets which increase quarterly.

At March 31, 2002, the Company was in compliance with all amended covenants.

NOTE 5. CONTINGENCIES

From time to time, the Company may become involved in litigation relating to claims arising from the ordinary course of business. The Company is defending against two claims filed by early customers, one an action filed in the federal district court in Massachusetts and the other an action filed in the federal district court in California. Both cases allege a variety of claims including that the software and services purchased from the Company did not satisfy certain contractual obligations and that the Company engaged in practices that they allege were unfair or misrepresentative. Both of these proceedings are still in the early stages of litigation, therefore, it is not possible to estimate the outcome of these contingencies.

In November 2001, a complaint seeking class action status was filed, against the Company, in the United States District Court for the Southern District of New York. The complaint is purportedly brought on behalf of all persons who purchased the Company's common stock from August 9, 2000, through December 6, 2000. The complaint names as defendants some of the Company's former and current officers, and several investment banking firms that served as managing underwriters of the Company's initial public offering. Among other claims, the complaint alleges liability under the Securities Act of 1933 and the Securities Exchange Act of 1934, on the grounds that the registration statement for the Company's initial public offering did not disclose that: (1) the underwriters had allegedly agreed to allow certain of their customers to purchase shares in the offering in exchange for alleged excess commissions paid to the underwriters; and (2) the underwriters had allegedly arranged for certain of their customers to purchase additional shares in the aftermarket at pre-determined prices under alleged arrangements to manipulate the price of the stock in aftermarket trading. The Company is aware that similar allegations have been made in numerous other lawsuits challenging initial public offerings conducted in 1998, 1999 and 2000. No specific amount of damages is claimed in the complaint involving the initial public offering. The Company intends to contest the claims vigorously. The Company is unable, at this time, to determine whether the outcome of the litigation will have a material impact on its results of operations or financial condition in any future period.

The Company believes that there are no other claims or actions pending or threatened against it, the ultimate disposition of which would have a material adverse effect on the Company.

NOTE 6. RESTRUCTURING CHARGES

Beginning in the quarter ending June 30, 2001 through the quarter ending December 31, 2001, the Company critically reviewed its operations and cost structure, and took actions to reduce costs and strengthen its position in executing its strategy. These decisions resulted in the involuntary termination of 207 employees. The terminations were from all functions of the Company's operations and included twenty-two employees from the closure of the India research facility. As a result of the headcount reduction, the Company recorded charges of $3.4 million in severance and related benefit charges. The Company consolidated its facilities at its Emeryville headquarters, which resulted in a total net charge of $4.6 million related to its excess facilities. These costs included a reversal of $2.2 million of previously accrued restructuring charges for the excess space at the Company's headquarters that resulted from amending the original lease to relieve the Company from some future rental obligations. The Company also recorded charges of $2.3 million consisting of impairment of

certain assets including leasehold improvements and furniture related to the excess facilities, computer hardware and software, and telecommunications equipment related to the workforce reduction. A rollforward of the restructuring-related liabilities follows.

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(in thousands)	SEVERANCE AND RELATED CHARGES	FACILITIES	FIXED ASSET WRITE-OFF	TOTALS
Restructuring charges	$ 1,597	$ 6,433	$ 1,694	$ 9,724
Amount paid	(817)	(354)	-	(1,171)
Non-cash charges	-	-	(1,694)	(1,694)
Accrued liabilities at June 30, 2001	$ 780	$ 6,079	-	$ 6,859
Restructuring charges	590	-	103	693
Amount paid	(1,007)	(405)	-	(1,412)
Non-cash charges	-	-	(103)	(103)
Accrued liabilities at September 30, 2001	$ 363	$ 5,674	$ -	$ 6,037
Restructuring charges (reversals)	1,224	(1,836)	523	(89)
Amount paid	(1,013)	(529)		(1,542)
Non-cash charges	(191)	(121)	(463)	(775)
Accrued liabilities at December 31, 2001	$ 383	$ 3,188	$ 60	$ 3,631
Restructuring charges (reversals)	-	-	(21)	(21)
Amount paid	(127)	(484)	21	(590)
Non-cash charges	-	-	-	-
Accrued liabilities at March 31, 2002	$ 256	$ 2,704	$ 60	$ 3,020
Short-term	$ 256	$ 1,637	$ 60	$ 1,953
Long-term	$ -	$ 1,067	$ -	$ 1,067

NOTE 7. NET LOSS PER SHARE

Basic and diluted net loss per share are computed using the weighted average number of common shares outstanding during each period. Since the Company has had a net loss for all periods presented, net loss per share on a diluted basis is equivalent to basic net loss per share. Common shares issuable upon exercise of stock options and warrants and upon conversion of convertible preferred stock are excluded because the effect would be anti-dilutive. A reconciliation of the numerator and denominator used in the calculation of basic and diluted net loss per share follows:

(in thousands)	THREE MONTHS ENDED MARCH 31,		NINE MONTHS ENDED MARCH 31,	
	2002	2001	2002	2001

Numerator:				
Net loss	$ (6,346)	$ (19,902)	$ (34,372)	$ (67,542
Beneficial conversion feature of redeemable convertible preferred stock	(212)	-	(579)	(5,977
Net loss attributable to common stockholders	$ (6,558)	$ (19,902)	$ (34,951)	$ (73,519
Denominator:				
Weighted average common shares	44,670	38,621	41,865	34,680
Weighted average unvested common shares subject to repurchase	(955)	(4,645)	(2,423)	(5,379
Shares used in computing basic and diluted net loss per share	43,715	33,976	39,442	29,301

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At March 31, 2002 and 2001, options to purchase 14,258,175 and 3,510,205 shares of common stock were outstanding with a weighted-average exercise price of $0.65 and $6.50, respectively. At March 31, 2002, the outstanding Series A Preferred Stock was convertible into 37.0 million shares of common stock. Warrants to purchase 600,000 shares of Series A Preferred Stock at $10.00 per share and 9.4 million shares of common stock at $1.00 per share, if exercised, were convertible into 12 million and 9.4 million shares of common stock, respectively, as of March 31, 2002. Providing that the remaining Series A Preferred Stock warrants are exercised, the Company will issue additional common stock warrants to purchase 2.9 million shares of common stock at $1.00 per share. These common stock equivalents have been excluded from the computation of diluted net loss per share because their effect would have been anti-dilutive. The weighted-average purchase prices of stock subject to repurchase were $2.32 and $2.14 as of March 31, 2002 and 2001, respectively.

NOTE 8. SERIES A PREFERRED STOCK FINANCING

The Company completed the sale of Series A Convertible Preferred Stock pursuant to the Purchase Agreement (the "Series A Preferred Financing") with Warburg Pincus Private Equity VIII L.P. and certain previous stockholders on October 9, 2001. The Company issued the following securities and rights to the investors participating in the Series A Preferred Financing:

- an aggregate of 1.3 million shares of Evolve's Series A Preferred Stock at a price of $10 per share;
- warrants to purchase up to an aggregate of 1.3 million additional shares of Series A Preferred Stock at a price of $10 per share (the "preferred stock warrants");
- warrants to purchase up to 6.5 million shares of common stock at a price of $1.00 per share (the "common stock warrants"); and
- the right to receive additional common stock warrants to purchase a number of shares of common stock equal to 25% of the number of shares of common stock into which the shares of Series A Preferred Stock issued upon exercise of the preferred stock warrants are convertible, at the time such preferred stock warrants are exercised.

As this transaction resulted in significant changes to the Company's stockholders' equity balances, the following table has been provided to summarize the activity in the statement of stockholders' equity during the nine

months ended March 31, 2002.

(in thousands)

	EQUITY PREFERRED STOCK		COMMON STOCK		
	SHARES	AMTS	SHARES	AMTS	API
Balances, June 30, 2001	-	$ -	40,052	$ 40	$250,
Issuance of p/s & p/s warrants, as amended, net	1,100	1	-	-	8,
Cancellation of preferred & commons stock warrants	-	-	-	-	
Issuance of common stock warrants, as amended	-	-	-	-	1,
Beneficial conversion feature on preferred stock	-	-	-	-	1,
Amortization of beneficial conversion feature on p/s	-	-	-	-	
Exercise of CEO p/s warrants in March 2002	550	-	-	-	5,
Issuance of common stock under stock purchase plans	-	-	221	-	
Issuance of common stock to Vivant! Corporation	-	-	4,563	5	
Modification of s/h n/r and other stock option awards	-	-	-	-	
Repurchase of common stock	-	-	-	-	
Reversal of unearned stock-based compensation	-	-	-	-	(5,
Amortization of stock-based compensation	-	-	-	-	
Foreign currency translation adjustment	-	-	-	-	
Net loss	-	-	-	-	
Balances, March 31, 2002	1,650	$ 1	44,836	$ 45	$262,

(in thousands)

	ACCUM OTHER COMPRE INCOME	ACCUM DEFICIT	TOTAL S/H EQUITY
Balances, June 30, 2001	$ 95	$(215,750)	$ 15,343
Issuance of p/s & p/s warrants, as amended, net	-	-	8,205
Cancellation of preferred & commons stock warrants	-	-	209
Issuance of common stock warrants, as amended	-	-	1,296
Beneficial conversion feature on preferred stock	-	-	1,158
Amortization of beneficial conversion feature on p/s	-	(579)	(56)
Exercise of CEO p/s warrants in March 2002	-	-	5,500
Issuance of common stock under stock purchase plans	-	-	101
Issuance of common stock to Vivant! Corporation	-	-	-
Modification of s/h n/r and other stock option awards	-	-	6,303
Repurchase of common stock	-	-	(12)
Reversal of unearned stock-based compensation	-	-	-
Amortization of stock-based compensation	-	-	4,032
Foreign currency translation adjustment	(13)	-	(13)
Net loss	-	(34,372)	(34,372)
Balances, March 31, 2002	$ 82	$(250,701)	$ 7,694