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SMARTFORCE PUBLIC LTD CO
Form 10-Q
November 14, 2001

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20548

FORM 10-Q

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

For the quarterly period ended September 30, 2001

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: 0-25674

SMARTFORCE PUBLIC LIMITED COMPANY
(Exact name of registrant as specified in its charter)

Republic of Ireland
(State or other jurisdiction of
incorporation or organization)

Not Applicable
(I.R.S. Employer Identification No.)

900 CHESAPEAKE DRIVE
REDWOOD CITY, CALIFORNIA 94063
(Address of principal executive offices, including zip code)

(650) 817-5900
(Registrant's telephone number, including area code)

Indicate by check mark whether 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 Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past ninety (90) days.

Yes No

The number of American Depositary Shares ("ADSs") (issued or issuable in exchange for Registrant's outstanding Ordinary Shares) outstanding as of November 12, 2001 was 56,592,257.

SMARTFORCE PUBLIC LIMITED COMPANY

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PART I FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

SMARTFORCE PUBLIC LIMITED COMPANY

CONDENSED CONSOLIDATED BALANCE SHEETS
(dollars in thousands)

	December 31,	Septemb
ASSETS	2000	2000
	-----	-----
CURRENT ASSETS		
Cash	\$ 65,412	\$ 78,412
Short term investments	42,545	44,545
Accounts receivable, net	76,458	88,458
Inventories	369	369
Recoverable and deferred tax assets, net	2,517	2,517
Prepaid expenses	12,467	21,467
	-----	-----
Total current assets	199,768	235,768
Intangible assets	73,194	71,194
Property and equipment, net	29,388	36,388

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Investments	3,616	9
Other assets	28,817	31
	-----	-----
Total assets	\$ 334,783	\$ 385
	=====	=====
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 6,961	\$ 5
Accrued payroll and related expenses	9,926	10
Other accrued liabilities	22,118	16
Deferred revenues	48,381	45
	-----	-----
Total current liabilities	87,386	77
NON-CURRENT LIABILITIES		
Minority equity interest	307	
Other liabilities	1,452	
	-----	-----
Total non current liabilities	1,759	
SHAREHOLDERS' EQUITY		
Ordinary Shares, E0.11 par value: 120,000,000 shares authorized at December 31, 2000 and September 30, 2001; issued and outstanding: 51,970,046 and 51,944,277 shares at December 31, 2000 and 56,274,654 and 56,248,885 at September 30, 2001, respectively	7,075	7
Additional paid-in capital	232,640	288
Accumulated profit	6,191	9
Capital Conversion Reserve Fund	581	
Capital redemption reserve	296	
Other comprehensive income (loss)	(1,143)	
Treasury stock	(2)	
	-----	-----
Total shareholders' equity	245,638	306
	-----	-----
Total liabilities and shareholders' equity	\$ 334,783	\$ 385
	=====	=====

See notes to condensed consolidated financial statements

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SMARTFORCE PUBLIC LIMITED COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(dollars in thousands, except per share amounts)

	Three Months Ended September 30,		En
	2000	2001	2
	----	----	---
Revenues	\$ 45,572	\$ 68,117	\$ 11
Cost of revenues	7,456	11,570	1

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Gross profit	38,116	56,547	9
Operating expenses:			
Research and development	11,189	12,775	3
Sales and marketing	26,423	33,825	7
General and administrative	4,954	5,272	1
Amortization of acquired intangibles	2,323	2,539	
Total operating expenses	44,889	54,411	12
Income (loss) from operations	(6,773)	2,136	(3)
Other income, net	1,069	709	
Income (loss) before provision (benefit) for income taxes	(5,704)	2,845	(2)
Provision (benefit) for income taxes	(338)	646	(
Net income (loss)	\$ (5,366)	\$ 2,199	\$ (2)
Net income (loss) per share - Basic	\$ (0.10)	\$ 0.04	\$
Shares used in computing net income (loss) per share -Basic	51,324	55,716	5
Net income (loss) per share - Diluted	\$ (0.10)	\$ 0.04	\$
Shares used in computing net income (loss) per share - Diluted	51,324	61,944	5

See notes to condensed consolidated financial statements

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SMARTFORCE PUBLIC LIMITED COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in thousands)

	Nine Months En	September 30
	2000	----
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	\$ (26,988)	\$
Adjustments to reconcile net income (loss) to net cash used by operating activities:		
Depreciation and amortization	14,995	
Accrued interest on short term investments	19	
Changes in operating assets and liabilities:		
Accounts receivable	(3,686)	
Inventories	(200)	

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Deferred tax assets	(2,310)
Prepaid expenses and other assets	(6,933)
Accounts payable	(628)
Accrued payroll, related expenses and other accrued liabilities	(4,766)
Deferred revenues	31,739

Net cash provided (used) by operating activities	1,242

CASH FLOWS FROM INVESTING ACTIVITIES	
Purchases of property and equipment	(8,385)
Payments to acquire Learning Productions, net assets of Advanced Education Systems and icGlobal net of cash acquired	(6,893)
Payments to acquire short term investments	(111,592)
Proceeds from sale of short term investments	108,583
Payments to acquire investments	(2,866)

Net cash used in investing activities	(21,153)

CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds from issuance of ordinary shares, net	10,171

Net cash provided by financing activities	10,171

Effect of exchange rate changes on cash and cash equivalents	12

Net decrease in cash and cash equivalents	(9,728)
Cash and cash equivalents at beginning of period	69,260

Cash and cash equivalents at end of period	\$ 59,532
	=====

See notes to condensed consolidated financial statements

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SMARTFORCE PUBLIC LIMITED COMPANY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. INTERIM CONSOLIDATED FINANCIAL STATEMENTS

These interim unaudited condensed and consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements. However, the Company believes that the disclosures are adequate to ensure that the information presented is not misleading. The accompanying interim financial statements should be read in conjunction with the financial statements and related notes included in the Company's Annual Report to Shareholders, as amended on Form 10-K/A, for the year ended December 31, 2000. In the opinion of management, all adjustments (consisting of normal recurring accruals), considered necessary for a fair presentation of financial position, results of operations and cash flows at the dates and for the periods presented have been included. The results of operations for the periods presented are not necessarily indicative of the results expected for the full financial year or for any future period.

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NOTE 2. COMPUTATION OF NET INCOME (LOSS) PER SHARE

Basic net income (loss) per share is calculated using the weighted average number of our ordinary shares outstanding during the period. Diluted net income per share is similarly calculated using the combined weighted average number of ordinary and dilutive potential ordinary shares, (as determined using the treasury stock method), such as shares issuable pursuant to the exercise of options outstanding.

The following table sets forth the computation of basic and diluted net income (loss) per share:

(dollars in thousands, except per share)

	THREE MONTHS ENDED SEPTEMBER 30,		
	2000	2001	2002
	----	----	----
Numerator:			
Numerator for basic and diluted net income (loss) per share - net income (loss) available to common shareholders	\$ (5,366)	\$ 2,199	\$ (1,000)
	=====	=====	=====
Denominator:			
Denominator for basic net income (loss) per share - weighted average shares	51,324	55,716	55,716
Effect of dilutive securities:			
Employee stock options	--	6,228	--
	-----	-----	-----
Denominator for diluted net income (loss) per share - adjusted weighted average shares and assumed conversion	51,324	61,944	61,944
	=====	=====	=====
Basic net income (loss) per share	\$ (0.10)	\$ 0.04	\$ (0.02)
	=====	=====	=====
Diluted net income (loss) per share	\$ (0.10)	\$ 0.04	\$ (0.02)
	=====	=====	=====

NOTE 3. COMPREHENSIVE INCOME (LOSS)

The components of comprehensive income (loss), net of tax, for the nine months ended September 30, 2001 and 2000 are as follows:

	Nine months ended September 30,	
	2000	2001
	----	----

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(dollars in thousands)		
Net income (loss)	\$ (26,988)	\$ 3,247
Other comprehensive income (loss)		
Cumulative effect of change in accounting Principle (SFAS 133)	--	3,703
Current period changes on cash flow hedges:		
Net amount reclassified into earnings	--	1,032
Net loss on cash flow hedges	--	(2,079)
Foreign currency translation adjustment	(1,255)	(906)
	-----	-----
Total comprehensive income (loss)	\$ (28,243)	\$ 4,997
	=====	=====

NOTE 4. SEGMENT GEOGRAPHIC AND CUSTOMER INFORMATION

The Company presents financial information for its three reportable operating segments: Americas, Europe Middle East Africa ("EMEA") and Ireland. The Americas and EMEA segments are sales operations and Ireland is the Company's research and development operation.

The Company and its subsidiaries operate in one industry segment, the development and marketing of e-Learning solutions. Operations outside of Ireland consist principally of sales and marketing.

The Company's products are developed in Ireland and sold to the Company's distribution subsidiaries in other geographic locations. These inter segment revenues are determined on arms length bases pursuant to which a fair profit is earned by the Irish development subsidiary and which is designed to comply with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators. All such inter segment revenues and costs of revenues are eliminated on consolidation.

The Company's Chief Operating Decision Maker ("CODM"), the Company's President and CEO, allocates resources and evaluates performance based on a measure of segment profit or loss from operations. The accounting policies of the reportable segments are the same as described in the summary of significant accounting policies in the Company's Annual Report on Form 10-K/A, as amended, for the year ended December 31, 2000. The Company's CODM does not view segment results below operating profit (loss), therefore, net interest income, other income and the provision (benefit) for income taxes are not broken out by segment below. The Company does not account for nor report to the CODM its assets or capital expenditures by segment, thus asset information is not provided on a segment basis.

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A summary of the segment financial information reported to the CODM is as follows:

NINE MONTHS ENDED SEPTEMBER

AMERICAS

EMEA

IRELAND

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	-----	----	-----
			(dollars in thousand)
Revenues -- external	\$ 149,721	\$ 22,266	\$ 16,657
Inter segment revenues	--	--	79,846
Depreciation and amortization	13,253	198	5,879
Segment operating income (loss)	(24,201)	(2,401)	38,706

	NINE MONTHS ENDED SEPTEMBER		
	-----	----	-----
	AMERICAS	EMEA	IRELAND
	-----	----	-----
			(dollars in thousand)
Revenues -- external	\$ 88,389	\$ 14,123	\$ 1,665
Inter segment revenues	--	--	52,219
Depreciation and amortization	5,177	258	2,960
Segment operating loss	(14,262)	(3,445)	(6,254)

Revenues from external customers, based on the location of the customer, are categorized by geographical areas as follows:

	THREE MONTHS ENDED SEPTEMBER 30,	
	-----	-----
	2000	2001
	----	----
Revenues		
Ireland	\$ 633	\$ 4,383
United States	30,703	48,166
United Kingdom	6,381	5,963
Other countries	7,855	9,605
Total	\$ 45,572	\$ 68,117
	=====	=====

Long lived assets are those assets that can be directly associated with a particular geographic area. These assets are categorized by geographical areas as follows:

	SEPTEMBER 30,	
	-----	-----
	2000	2001
	----	----
	(dollars in thousands)	
Long Lived Assets		
Ireland	\$ 65,063	\$ 62,026

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United States	52,543	59,283
Other countries	15,516	28,169
	-----	-----
Total	\$133,122	\$149,478
	=====	=====

The Company regards its e-Learning solutions as homogenous products and services.

NOTE 5. ACQUISITIONS

On April 2, 2001, we acquired icGlobal, a provider of Learning Management System (LMS) software. The LMS software enables global organizations, content providers and institutions to develop, track and manage all e-Learning events and instructor-led-training, empowering administrators to manage their entire learning environment. We issued to the shareholders of icGlobal the right to acquire 100,000 ADSs as consideration for the outstanding securities of icGlobal. Such shareholders of icGlobal have also received resale registration rights with respect to such ADSs. The transaction was accounted for under the purchase method of accounting in accordance with generally accepted

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accounting principles. We recorded goodwill and intangible assets of approximately \$3.2 million as a result of the acquisition of icGlobal. These intangibles are being amortized on a straight line basis over 5 years.

On August 29, 2001, we acquired substantially all of the assets of IMPAXselling.com, a sales performance company providing global enterprises with web-based learning solutions designed to improve sales and account management performance. We issued 92,394 ADSs to the shareholders of IMPAXselling.com as consideration for the assets of IMPAXselling.com. The transaction was accounted for under the purchase method of accounting in accordance with generally accepted accounting principles. We recorded intangible assets of approximately \$3.3 million as a result of the acquisition of IMPAXselling.com. These intangibles are being amortized on a straight line basis over 5 years.

NOTE 6. RECENT ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board issued Statement No. 133 "Accounting for Derivative Instruments and Hedging Activities" ("Statement 133") in June 1998. Statement 133, which requires all derivative instruments to be recognized as either assets or liabilities on the balance sheet at their fair value, provides a comprehensive and consistent standard for the recognition and measurement of derivatives and hedging activities. As amended, this statement is effective for fiscal years beginning after June 15, 2000. The Company applied the new rules prospectively to transactions beginning in the first quarter of 2001. The cumulative effect of the change in accounting principle due to the adoption of Statement 133 resulted in the recognition of a net loss of \$170,811 in the income statement and a net gain of \$3.7 million in other comprehensive income. During the nine months ended September 30, 2001, the amount recorded in earnings relating to cash flow ineffectiveness was a loss of \$718,447. Included in other comprehensive income (loss) for the nine months ended September 30, 2001 was a profit of \$2.6 million in respect of the cash flow hedges held at September 30, 2001.

In June 2001, the FASB issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS 141 requires that all business combinations be accounted for under the purchase method only and that certain acquired intangible assets in a business combination be recognized as

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assets apart from goodwill. SFAS No. 142 requires that goodwill and other intangible assets with indefinite lives acquired in a business combination before July 1, 2001 should not be amortized. The statement further requires that the fair value of goodwill and other intangible assets with indefinite lives be tested for impairment upon adoption of this statement, annually and upon the occurrence of certain events. SFAS 141 is effective for all business combinations initiated after June 30, 2001 and for all business combinations accounted for by the purchase method for which the date of acquisition is after June 30, 2001. The provisions of SFAS 142 will be effective for fiscal years beginning after December 15, 2001, and will thus be adopted by the Company, as required, in fiscal year 2002. The impact of SFAS 141 and SFAS 142 on the Company's financial statements has not yet been determined.

ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

We provide comprehensive, integrated e-Learning solutions that help businesses deploy knowledge across their extended enterprise of employees, customers, suppliers, distributors and other business partners. Our hosted e-Learning platform provides access to a comprehensive offering of dynamic, continuously updated learning events and resources. Our platform allows organizations to customize their e-Learning environment to meet their corporate objectives and to train their employees and business partners quickly, efficiently and effectively. Our platform includes a learning content management system (LCMS) that allows organizations to create customized learning paths that combine our learning events with internally-created and third party learning events. Our platform also includes a learning management system (LMS) to help managers track and assess the effectiveness of their training initiatives as well as a variety of assessment and feedback tools to help users better understand their educational progress. We also offer "solution sets", which are productized versions of our platform, content and tools focusing on enabling specific business processes.

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Prior to 2000, we derived our revenues primarily under a software license model pursuant to license agreements under which customers license usage of delivered software products for a period of one, two or three years. On each anniversary date during the term of multi-year license agreements, customers have been generally allowed to exchange any or all of the licensed products for an equivalent number of alternative products within our library. The first year license fee has historically been generally recognized as revenue at the time of delivery of all products, provided a signed contract or other persuasive evidence of an arrangement exists, our fees are fixed or determinable and collections of accounts receivable are probable. Subsequent annual license fees under the software license model are recognized on each anniversary date, provided a signed contract or other persuasive evidence of an arrangement exists, our fees are fixed or determinable and collections of accounts receivable are probable. Revenues from license agreements providing product exchange rights other than annually during the term of the agreement are deferred and recognized ratably over the contract period.

During 2000 we migrated the majority of our business from the software license model to an e-Learning rental model, under which we rent to our customers access to our learning environment for a certain period of time, such as one, two or three years. Under the e-Learning rental model, revenue derived from e-Learning rental agreements is generally deferred and recognized ratably over the term of the relevant agreement, rather than annually in advance as was the case under the historical software license model, provided a signed contract

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or other persuasive evidence of an arrangement exists, our fees are fixed or determinable and collections of accounts receivable are probable.

The cost of satisfying any post contract support, or PCS, is accrued at the time revenue is recognized, as PCS fees are included in the annual license fee, the estimated cost of providing PCS during the agreements is insignificant and unspecified upgrades or enhancements offered have been and are expected to be minimal and infrequent. For multi-element agreements where vendor specific objective evidence exists to allocate the total fee among the various elements of the agreement each element is recognized as appropriate. Where no such vendor specific objective evidence exists revenue is recognized ratably over the life of the agreement.

In addition, we derive revenues from sales of our products, which are recognized upon shipment, net of allowances for estimated future returns and for excess quantities in distribution channels, provided persuasive evidence of an arrangement exists, our fees are fixed or determinable, and collections of accounts receivable are probable.

Our e-Learning agreements may have other accounting and operating model consequences that are materially different from our software licensing structure. For example, in the second quarter of 1999, we entered into an agreement with a major customer to provide an outsourced virtual university for technical education. Under the contract, the customer has licensed educational software from us, and has also contracted for professional services, management fees, on-line mentoring services and certain other items. In addition, the agreement provides for the reselling by us of third parties' instructor-led training to the customer. Revenues from the non-software licenses component of this agreement, which represent a substantial majority of the firmly contracted amount with the customer and all of the potential incremental revenues over the firmly contracted amount, will generally be recognized as services are performed, provided a signed contract or other persuasive evidence of an arrangement exists, the Company's fees are fixed and determinable and collections of accounts receivable are probable. Since that time an increasing number of customers, including most of our largest customers, have purchased a variety of different products and services from us, with different revenue recognition and operating model profiles. We expect to continue to experience increasing numbers of customers who fit this profile in the future.(1)

Moreover, the gross margins associated with the non-software license and non-rental components (and in particular professional services and the resale of third-party instructor-led training) of these types of agreements are expected to be substantially lower than the gross margins typically associated with our software license agreements.(2)

In recent years, we have entered into several content development and marketing alliances with key vendors of technology software under which we develop e-Learning content for training on specific products. Under certain of our development and marketing alliances, our partners have agreed to fund certain product development costs. We recognize such funding as revenues on a percentage of completion basis, and the costs associated with such revenues are reflected as cost of revenues. These agreements have the effect of shifting expenses associated with developing certain new products from research and development to cost of revenues. We expect that cost of revenues may fluctuate from period to period in the future based upon many factors. We do not expect funding from development partners to contribute significantly to revenues in future years.

- (1) This paragraph consists of forward-looking statements reflecting our current expectations. Our actual future performance may differ materially from our current expectations. You are strongly encouraged to review the section entitled "Additional Risk Factors That Could Affect Operating

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Results" commencing on page 16 and discussions elsewhere in this Quarterly Report on Form 10-Q of the factors that could affect future performance.

- (2) This paragraph consists of forward-looking statements reflecting our current expectations. Our actual future performance may differ materially from our current expectations. You are strongly encouraged to review the section entitled "Additional Risk Factors That Could Affect Operating Results" commencing on page 16 and discussions elsewhere in this Quarterly Report on Form 10-Q of the factors that could affect future performance.

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RECENT DEVELOPMENTS

On October 11, 2001, we acquired SkillScape Solutions, Inc., a leading global provider of competency management systems. We issued 157,654 ADSs and cash of \$0.6 million to the shareholders of SkillScape Solutions, Inc., as consideration for the outstanding securities of SkillScape Solutions, Inc. The transaction will be accounted for under the purchase method of accounting in accordance with generally accepted accounting principles.

The combination of the operations of other recent acquisitions, icGlobal, IMPAXselling.com and SkillScape Solutions, Inc., with our operations will result in an increase in our research and development expenses. In addition, the amortization of goodwill and any intangible assets acquired as part of icGlobal, IMPAXselling.com and SkillScape Solutions, Inc., will negatively impact the results of operations in future periods as may any potential impairment of goodwill under SFAS 142. Unanticipated contingencies that would substantially increase the costs of combining the operations of icGlobal, IMPAXselling.com and SkillScape Solutions, Inc., with us may occur.(3)

As we discussed on our public conference calls on October 1, 2001 and October 17, 2001, the terrorist events of September 11, 2001 and their aftermath had a material adverse effect on our third quarter bookings. As we also discussed on these conference calls, we expect that these events will negatively affect our bookings for the fourth quarter and beyond. It is not possible to predict the outcome of the recent escalation of hostilities between the United States and certain countries and persons related to the events of September 11. The continuation of these hostilities could result in further weakness in the economy which would have a further adverse impact on our operating results and financial condition.

- (3) This paragraph consists of forward-looking statements reflecting our current expectations. Our actual future performance may differ materially from our current expectations. You are strongly encouraged to review the section entitled "Additional Risk Factors That Could Affect Operating Results" commencing on page 16 and discussions elsewhere in this Quarterly Report on Form 10-Q of the factors that could affect future performance

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RESULTS OF OPERATIONS

The following table sets forth certain consolidated statements of operations data as a percentage of revenues:

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	THREE MONTHS ENDED SEPTEMBER 30,	
	2000	2001
	----	----
Revenues	100%	100%
Cost of revenues	16.4	17.0
	-----	-----
Gross Profit	83.6	83.0
Operating expenses:		
Research and development	24.5	18.8
Sales and marketing	58.0	49.7
General and administrative	10.9	7.7
Amortization of acquired intangibles	5.1	3.7
	-----	-----
Total operating expenses	98.5	79.9
	-----	-----
Income (loss) from operations	(14.9)	3.1
Other income, net	2.4	1.0
	-----	-----
Income (loss) before provision for income taxes	(12.5)	4.1
Provision (benefit) for income taxes	(0.7)	0.9
	-----	-----
Net income (loss)	(11.8)%	3.2%
	=====	=====

REVENUES

Revenues increased to \$68.1 million in the three months ended September 30, 2001 from \$45.6 million in the three months ended September 30, 2000, and increased to \$195.5 million in the nine months ended September 30, 2001 from \$110.5 million in the nine months ended September 30, 2000. The increase in revenues in the 2001 periods as compared to the same periods in 2000 was primarily attributable to increased customer demand for our e-Learning solutions as well as the deferral of revenues from 2000 to 2001 as a result of the shift in our business model.

Revenues in the United States for the three months and nine months ended September 30, 2001 were \$48.1 million (or 71% of revenues) and \$137.5 million (or 70% of revenues), respectively, compared to \$30.7 million (or 67% of revenues) and \$72.6 million (or 66% of revenues) for the three and nine month periods ended September 30, 2000, respectively.

Revenues in the United Kingdom for the three months and nine months ended September 30, 2001 were \$6.0 million (or 9% of revenues) and \$19.0 million (or 10% of revenues), respectively, compared to \$6.4 million (or 14% of revenues) and \$16.7 million (or 15% of revenues) for the three and nine month periods ended September 30, 2000, respectively. Revenues in Ireland for the three and nine months ended September 30, 2001 were \$4.4 million (or 6% of revenues) and \$5.9 million (or 3% of revenues) compared to \$0.6 million (or 2% of revenues) and \$2.2 million (or 2% of revenues) for the nine months ended September 30, 2000.

In addition, revenues from outside the United States, United Kingdom and Ireland (principally from Asia Pacific, Europe (other than the United Kingdom and Ireland), Latin America, Canada, South Africa and the Middle East) in the three and nine months ended September 30, 2001 were \$9.6 million (or 14% of

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revenues) and \$33.1 million (or 17% of revenues), compared to \$7.9 million (or 17% of revenues) and \$19.0 million (or 17% of revenues) for the three and nine months ended September 30, 2000.

Because a significant proportion of our business is conducted outside the United States, we are subject to a number

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of risks associated with doing business in other countries, including risks related to currency fluctuations.

COST OF REVENUES

Cost of revenues includes the cost of materials (such as packaging and documentation), royalties to third parties, the portion of development costs associated with funded development projects, hosting, the cost of providing professional services, fulfillment, shipping and handling costs and the amortization of the cost of purchased products.

Gross margins decreased slightly to 83.0% and 83.6% in the three and nine months ended September 30, 2001, from 83.6% and 83.7% in the three and nine months ended September 30, 2000. The lower gross margins for the three and nine months ended September 30, 2001 were attributable to the modest increase in the proportion of revenues derived from services in 2001 as compared to 2000.

We expect that cost of revenues may fluctuate from period to period in the future based upon many factors, including the rate of migration of our customers to our e-Learning solutions, the revenue mix (including between software licenses, professional services and products licensed from third parties) and the timing of expenses associated with development and marketing alliances. In particular we expect that professional services may represent an increasing portion of our revenues. (4)

OPERATING EXPENSES

Our operating expenses increased in dollar terms in the three and nine months ended September 30, 2001 as compared to the three and nine months ended September 30, 2000, primarily as a result of the growth in our business and our ongoing investments in our e-Learning solutions. Operating expenses as a percentage of revenues decreased in the three and nine months ended September 30, 2001 as compared to the same periods in 2000, primarily as a result of the rapid adoption of our e-Learning solutions in 2000 which resulted in the deferral of revenues from 2000 into future periods.

RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses consist primarily of salaries and benefits, related overhead costs, travel expenses and fees paid to outside consultants.

Research and development expenses increased in the three and nine months ended September 30, 2001 to \$12.8 million and \$38.0 million, respectively, from \$11.2 million and \$30.0 million in the three and nine months ended September 30, 2000. The increase in research and development is primarily the result of the expansion of our e-Learning content and platform capabilities and the continued enhancement of our e3 application architecture, all of which are required to further develop and expand our e-Learning solutions.

We believe that significant investment in research and development is

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required to maintain and expand our e-Learning infrastructure and to remain competitive in the corporate training market. We are committed to maintaining this investment, and accordingly, research and development expenses may increase in future periods. (5)

Software development costs are accounted for in accordance with Statement of Financial Accounting Standards No. 86, under which we are required to capitalize software development costs after technological feasibility has been established. To date, development costs after establishment of technological feasibility have been immaterial, and all software development costs have been expensed as incurred.

- (4) This paragraph consists of forward-looking statements reflecting our current expectations. Our actual future performance may differ materially from our current expectations. You are strongly encouraged to review the section entitled "Additional Risk Factors That Could Affect Operating Results" commencing on page 16 and discussions elsewhere in this Quarterly Report on Form 10-Q of the factors that could affect future performance.
- (5) This paragraph consists of forward-looking statements reflecting our current expectations. Our actual future performance may differ materially from our current expectations. You are strongly encouraged to review the section entitled "Additional Risk Factors That Could Affect Operating Results" commencing on page 16 and discussions elsewhere in this Quarterly Report on Form 10-Q of the factors that could affect future performance.

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SALES AND MARKETING EXPENSES

Sales and marketing expenses consist primarily of salaries and commissions, travel expense, advertising and promotional expenses and related overhead costs.

These expenses increased in absolute terms in the three and nine months ended September 30, 2001 to \$33.8 million and \$99.2 million, respectively, from \$26.4 million and \$74.4 million for the three and nine months ended September 30, 2000. The increase was primarily attributable to higher absolute dollar commission costs associated with increased revenues.

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses consist primarily of salaries and benefits, travel expenses, legal, accounting and consulting fees and related overhead costs for administrative officers and support personnel.

General and administrative expenses increased in absolute terms in the three and nine months ended September 30, 2001 to \$5.3 million and \$16.4 million, respectively, compared to \$5.0 million and \$14.3 million for the three and nine months ended September 30, 2000.

AMORTIZATION OF ACQUIRED INTANGIBLES

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Amortization of acquired intangibles for the three and nine months ended September 30, 2001 was \$2.5 million and \$7.3 million, respectively, compared to \$2.3 million and \$6.3 million, respectively for the three and nine months ended September 30, 2000. Amortization of acquired intangibles increased due to the additional amortization of acquired intangibles in the three and nine months ended September 30, 2001 as compared to the three and nine months ended September 30, 2000, primarily as a result of the acquisition of Learning Productions in April 2000 and icGlobal in April 2001.

In June 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets" which will require us to discontinue the amortization of goodwill and other intangible assets with indefinite lives acquired in business combinations we have completed in the past. We will adopt SFAS 142, as required beginning in 2002 and thus will only continue to amortize acquired intangibles, other than goodwill, with definite lives. The overall impact of SFAS 142 on our operating results and financial condition have not yet been determined. However, following the Company's adoption of SFAS 142 on January 1, 2002, we estimate that the quarterly amortization of acquired intangibles, based on our acquired intangibles to date, will be approximately \$2.5 million. We expect the amortization of identifiable intangible assets to increase if we continue to acquire companies and technologies.

OTHER INCOME, NET

Other income, net, comprises interest income, interest expense and foreign currency exchange gains and losses.

We recognized other income, net, of \$0.7 million and \$2.1 million in the three and nine months ended September 30, 2001, respectively, as compared to other income, net, of \$1.1 million and \$3.3 million in the three and nine months ended September 30, 2000. Other income decreased primarily due to lower interest income resulting from lower prevailing U.S. interest rates as well as foreign exchange losses. Included in other income, net, was net exchange losses of \$0.1 million and \$1.0 million for the three and nine months ended September 30, 2001, compared to net exchange losses of \$0.5 million and \$1.0 million for the three and nine months ended September 30, 2000. The net exchange losses incurred were primarily attributable to the adoption of Statement 133 on January 1, 2001, and the strengthening of the U.S. dollar against the Euro and other currencies.

Our consolidated financial statements are prepared in dollars, although several of our subsidiaries have functional currencies other than the dollar, and a significant portion of our revenues, costs and assets and those of our subsidiaries are denominated in currencies other than their respective functional currencies. We have significant subsidiaries in the United Kingdom, Australia, the Netherlands and Canada whose functional currencies are their local currencies and the majority of whose sales and operating expenses other than cost of goods sold are denominated in their

respective local currencies. In addition, our Irish subsidiaries, whose functional currency is the U.S. dollar, incur substantial operating expenses denominated in Irish pounds. Fluctuations in exchange rates may have a material adverse effect on our results of operations, particularly our operating margins, and could result in exchange losses, as it has done in the three and nine months ended September 30, 2001 and 2000. The impact of future exchange rate fluctuations on our results of operations cannot be accurately predicted.

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We entered into forward currency exchange contracts to hedge identified expenses denominated in Irish pounds. We have not sought to hedge risks associated with fluctuations in the exchange rates of other currencies against the U.S. Dollar, but may undertake such transactions in the future. Any hedging techniques implemented by us may not be successful in eliminating or reducing the effects of currency fluctuations. Fluctuations in exchange rates may have a material adverse effect on our results of operations, particularly our operating margins, and could result in exchange losses. The impact of future exchange rate fluctuations on the results of operations cannot be accurately predicted.(6)

Other income, net may fluctuate in future periods as a result of movements in cash, cash equivalents and short-term investment balances, interest rates, foreign currency exchange rates movement on derivative instruments and asset and investment disposals and write downs.

PROVISION FOR INCOME TAXES

We operate as a holding company with operating subsidiaries in several countries, and each subsidiary is taxed based on the laws of the jurisdiction in which it operates. Because taxes are incurred at the subsidiary level, and one subsidiary's tax losses cannot be used to offset the taxable income of subsidiaries in other tax jurisdictions, our consolidated effective tax rate may increase to the extent that we report tax losses in some subsidiaries and taxable income in others.

We have significant operations and generate a majority of our taxable income in the Republic of Ireland, and certain of our Irish operating subsidiaries are taxed at rates substantially lower than tax rates in effect in the United States and other countries in which we have operations. Two Irish subsidiaries currently qualify for a 10% tax rate and another Irish subsidiary is income tax exempt. If such subsidiaries were no longer to qualify for such tax rates or if the tax laws were rescinded or changed, our operating results could be materially adversely affected. Moreover, because we incur income tax in several countries, an increase in our profitability in one or more of these countries could result in a higher overall tax rate. In addition, if tax authorities were to challenge successfully the manner in which profits are recognized among our subsidiaries, our taxes could increase and our cash flow and net income could be materially adversely affected.

We recorded a tax charge of \$0.6 million and \$1.4 million, at an effective tax rate of 12%, before amortization of acquired intangibles, in the three and nine months ended September 30, 2001. We recorded a tax benefit of \$0.3 million and \$2.3 million in the three and nine months ended September 30, 2000, as a result of the loss for 2000, which was recognized for tax purposes by one of our Irish subsidiaries.

LIQUIDITY AND CAPITAL RESOURCES

Cash and short-term investments at September 30, 2001 were \$122.8 million compared to \$108.0 million at December 31, 2000. Working capital was \$157.8 million as of September 30, 2001 compared to \$112.4 million as of December 31, 2000. The increase in cash and short term investments is due principally to the increase in proceeds from the issuance of ordinary shares.

CASH FLOWS FROM OPERATING ACTIVITIES. Net cash used by operating activities was \$10.9 million for the nine months ended September 30, 2001 compared to net cash provided by operating activities of \$1.2 million for the nine months ended September 30, 2000. During the nine months ended September 30, 2001, cash outflows from operations increased from that for the nine months ended September 30, 2000 primarily due to a decrease in deferred revenue from that at December 31, 2000 to September 30, 2001 as compared to the increase in deferred revenue from December 31, 1999 to September 30, 2000. This decrease in deferred revenue

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was offset by net income of \$3.2 million for the nine months ended September 30, 2001 as compared to a net loss of \$27.0 million for the nine months ended September 30, 2000.

- (6) This paragraph consists of forward-looking statements reflecting our current expectations. Our actual future performance may differ materially from our current expectations. You are strongly encouraged to review the section entitled "Additional Risk Factors That Could Affect Operating Results" commencing on page 16 and discussions elsewhere in this Quarterly Report on Form 10-Q of the factors that could affect future performance.

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CASH FLOWS FROM INVESTING ACTIVITIES. Net cash used by investing activities was \$27.1 million in the nine months ended September 30, 2001 compared to net cash used by investing activities of \$21.1 million for the nine months ended September 30, 2000. The increase in cash outflow from investing was primarily due to increased capital expenditure required to continue to expand our e-Learning infrastructure. We expect to make significant investments to our e-Learning infrastructure and information systems to support our e-Learning solutions and the growth in operations. (7)

CASH FLOWS FROM FINANCING ACTIVITIES. Net cash provided by financing activities increased to \$50.9 million for the nine months ended September 30, 2001 compared to \$10.2 million for the nine months ended September 30, 2000. The increase is attributable to increased employee stock option exercises during the 2001 period.

We believe our existing cash, cash equivalents and short-term investments and cash to be generated from operations will be sufficient to meet our expected working capital and capital expenditure requirements for at least the next twelve months. (8) We may from time to time consider the acquisition of complementary businesses, products or technologies, which may require additional financing or pursue other strategic capital raising.

ADDITIONAL RISK FACTORS THAT COULD AFFECT OPERATING RESULTS

IMPORTANT NOTE ABOUT FORWARD LOOKING STATEMENTS

In addition to historical statements, this Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Words such as "anticipates", "expects", "intends", "plans", "believes", "seeks", "estimates" and similar expressions identify such forward looking statements. These forward looking statements are not guarantees of future performance and are subject to certain risks and uncertainties that could cause actual results to differ materially from those expressed or forecasted. Actual results may vary because of factors such as product ship schedules, life cycles, terms and conditions, product mix, competitive products and pricing, customer demand, technological shifts, litigation and other issues discussed elsewhere in this Quarterly Report and in our most recent Annual Report, as amended on Form 10-K/A for the fiscal year ended December 31, 2000. These forward-looking statements reflect management's opinions only as of the date hereof, and we assume no obligation unless required by law to revise or publicly release the results of any revision to these forward-looking statements. Risks and uncertainties include, but are not limited to, those discussed in the section entitled "Additional Risk Factors That Could Affect

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Operating Results." Other risks and uncertainties are disclosed in our SEC filings, including our Annual Report, as amended on Form 10-K/A, for the year ended December 31, 2000. Historical results are not necessarily indicative of trends in operating results for any future period.

In addition to the other factors identified in this Quarterly Report on Form 10-Q, the following risk factors could materially and adversely affect our future operating results and could cause actual events to differ materially from those predicted in our forward looking statements relating to our business. These risk factors should be carefully considered in evaluating SmartForce and its business because such factors currently have a significant impact on SmartForce's business, operating results and financial condition.

- (7) This paragraph consists of forward-looking statements reflecting our current expectations. Our actual future performance may differ materially from our current expectations. You are strongly encouraged to review the section entitled "Additional Risk Factors That Could Affect Operating Results" commencing on page 17 and discussions elsewhere in this Quarterly Report on Form 10-Q of the factors that could affect future performance.
- (8) This statement is a forward-looking statement and actual results may differ materially depending on a variety of factors, including variable operating results or presently unexpected uses of cash such as mergers and acquisitions.

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OUR QUARTERLY OPERATING RESULTS MAY FLUCTUATE SIGNIFICANTLY. THIS LIMITS YOUR ABILITY TO EVALUATE OUR HISTORICAL FINANCIAL RESULTS AND INCREASES THE LIKELIHOOD THAT OUR RESULTS WILL FALL BELOW MARKET ANALYSTS' EXPECTATIONS, WHICH COULD CAUSE THE PRICE OF OUR ADSS TO DROP RAPIDLY AND SEVERELY.

We have in the past experienced fluctuations in our quarterly operating results and anticipate that these fluctuations will continue and could intensify in the future. As a result, we believe that our quarterly revenue, expenses and operating results are likely to vary significantly in the future. Thus, it is likely that in some future quarters our results of operations will be below the expectations of public market analysts and investors, which could have a severe adverse effect on the price of our ADSSs. For example, our revenue for the quarter ended September 30, 1998 did not increase at a rate comparable to prior quarters. As a direct result, the trading price of our ADSSs decreased rapidly and significantly, having an extreme adverse effect on the value of an investment in our securities.

Our operating results have historically fluctuated, and may in the future continue to fluctuate, as a result of factors, which include:

- the size and timing of new and renewal agreements;
- the rate at which we continue to migrate our customers to our e-Learning solutions;
- the number and size of outsourced virtual university agreements or other agreements providing for professional services or the resale of instructor-led training;
- the mix of revenue between content, e-Learning platform, professional services and products licensed from third parties;
- royalty rates;

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- the announcement, introduction and acceptance of new products, product enhancements and technologies by us and our competitors;
- the mix of sales between our field sales force, our other direct sales channels and our telesales sales channels;
- the impact of any unanticipated decline in net revenues in any particular quarter as compared to the relatively fixed nature of our expense levels in the short term;
- general conditions in the U.S. or the international economy;
- general conditions in our market or the markets served by our customers in the U.S.;
- competitive conditions in the industry;
- the loss of significant customers;
- delays in availability of existing or new products;
- the spending patterns of our customers;
- litigation costs and expenses;
- currency fluctuations;
- the length of sales cycles.

DEMAND FOR OUR PRODUCTS AND SERVICES MAY BE ESPECIALLY SUSCEPTIBLE TO ADVERSE ECONOMIC CONDITIONS.

Our business and financial performance may be damaged by adverse financial conditions affecting our target customers or by a general weakening of the economy. Some companies may not view training products and services as critical to the success of their businesses. If these companies experience disappointing operating results, whether as a result of adverse economic conditions, competitive issues or other factors, they may decrease or forego education and training expenditures before limiting their other expenditures.

In addition, the general condition of the economy, and by extension our business, can be affected by social, political and military conditions. For example, the terrorist events of September 11, 2001 and their aftermath had a material adverse effect on our third quarter bookings. It is not possible to predict the outcome of the recent escalation of hostilities between the United States and certain countries and persons related to the events of September 11. The continuation of these hostilities could result in further weakness in the economy which would have an adverse impact on our operating results and financial condition.

OUR EXPERIENCE IN SELLING FULLY INTEGRATED, INTERNET-BASED LEARNING SOLUTIONS, IS RELATIVELY LIMITED.

In the fourth quarter of 1999 we introduced SmartForce e-Learning, a hosted Internet-based learning solution. While the results of our efforts to migrate our business to the e-Learning model and market these solutions to our customers have exceeded our expectations, we have relatively limited experience with these solutions, which makes our historical results of limited value in predicting the potential success of this initiative. The ultimate success of this initiative will depend on our ability to continue to expand and enhance our e-Learning infrastructure, to market and sell the new e-Learning solutions to

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existing and prospective customers, to host, operate and manage our destination site, and to attract and retain key management and technical personnel.

We may not be successful in these efforts and the economic terms of any arrangements that might be expected may not be as favorable as the traditional licensing agreements. We believe that a lack of success in this regard could have a material negative effect on us. Moreover, the arrangements with our customers under the e-Learning model have had and will continue to have accounting and operating model consequences that would also be materially different from the consequences of our traditional software licensing model.

OUR OPERATING RESULTS ARE SUBJECT TO SEASONAL FLUCTUATIONS WHICH MAY ADVERSELY IMPACT OUR BUSINESS.

Our operating results are subject to seasonal fluctuations, based in part on customers' annual budgetary cycles and in part on the annual nature of sales quotas. These seasonal trends have in the past caused revenues in the first quarter of a year to be less, perhaps substantially so, than revenues for the immediately preceding fourth quarter. We expect that these seasonal trends could continue to adversely affect our revenues. In addition, we have in past years added significant headcount in the sales and marketing and research and development functions in the first quarter, and to a lesser extent, the second quarter. Because these headcount additions do not immediately contribute significant revenues, our operating margins in the earlier part of the year tend to be significantly lower than in the later parts of the year. In addition, many technology companies also experience a seasonal downturn in demand during the summer months. These seasonal trends may have a material adverse effect on our results of operations.

WE RELY ON STRATEGIC ALLIANCES THAT MAY NOT CONTINUE IN THE FUTURE.

We have developed strategic alliances to develop and market many of our products, and we believe that an increasing proportion of our future revenues may be attributable to products developed and marketed through these and other future alliances. However, these relationships are not exclusive and we may be unable to continue to develop future

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products through these alliances in a timely fashion or may be unable to negotiate additional alliances in the future on acceptable terms or at all.

The marketing efforts of our partners may also disrupt our direct sales efforts. Our development and marketing partners could pursue their existing or alternative training programs in preference to and in competition with those being developed by us. In the event that we are unable to maintain or expand our current development and marketing alliances or enter into new development and marketing alliances, our operating results and financial condition could be materially adversely affected. Furthermore, we are required to pay royalties to our development and marketing partners on products developed with them, which reduces our gross margins. We expect that cost of revenues may fluctuate from period to period in the future based upon many factors, including the revenue mix (between content, e-Learning platform, services and partner's products) and the timing of expenses associated with development and marketing alliances. In addition, the collaborative nature of the development process under these alliances may result in longer development times and less control over the timing of product introductions than for e-Learning offerings developed solely by us. Our strategic alliance partners may from time to time renegotiate the terms of our agreement with them and could result in changes to the royalty

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arrangements, which could adversely effect our results of operations.

OUR SUCCESS DEPENDS ON OUR ABILITY TO MEET THE NEEDS OF THE RAPIDLY CHANGING MARKET.

The market for interactive education and training is influenced by rapidly changing technology, evolving industry standards, changes in customer requirements and preferences and frequent introductions of new products and services embodying new technologies. New methods of providing interactive education in a technology-based format are being developed and offered in the marketplace, including intranet and Internet offerings. Many of these new offerings involve new and different business models and contracting mechanisms. In addition, multimedia and other product functionality features are being added to the educational software. Accordingly, our future success will depend upon the extent to which we are able to develop and implement products which address these emerging market requirements on a cost effective and timely basis. Product development is risky because it is difficult to foresee developments in technology, coordinate technical personnel and identify and eliminate design flaws. Any significant delay in releasing new products could have a material adverse effect on the ultimate success of our products and could reduce sales of predecessor products. We may not be able to introduce new products on a timely basis. In addition, new products introduced by us may fail to achieve a significant degree of market acceptance or, once accepted, may fail to sustain viability in the market for any significant period. If we are unsuccessful in addressing the changing needs of the marketplace due to resource, technological or other constraints, or in anticipating and responding adequately to changes in customers' software technology and preferences, our business and results of operations would be materially adversely affected.

THE SUCCESS OF OUR E-LEARNING STRATEGY DEPENDS ON THE RELIABILITY AND CONSISTENT PERFORMANCE OF OUR INFORMATION SYSTEMS AND INTERNET INFRASTRUCTURE.

The success of our e-Learning strategy is highly dependent on the consistent performance of our information systems and Internet infrastructure. If our Web site fails for any reason or if we exercise any unscheduled down times, even for only a short period of time, our business and reputation could be materially harmed. We have in the past experienced performance problems and unscheduled downtime, and these problems could occur. We rely on third parties for proper functioning of our computer infrastructure, delivery of our e-Learning application and the performance of our destination site. Our systems and operations could be damaged or interrupted by fire, flood, power loss, telecommunications failure, break-ins, earthquake and similar events. Any system failures could adversely affect customer usage of our solutions and user traffic results in any future quarters, which could adversely affect our revenues and operating results and harm our reputation with corporate customers, subscribers and commerce partners. A key element of our strategy is to generate a high volume of traffic to the Web site and create a significant subscriber base. Accordingly, the satisfactory performance, reliability and availability of our Web site and computer infrastructure is critical to our reputation and ability to attract and retain corporate customers, subscribers and commerce partners. We cannot accurately project the rate or timing of any increases in traffic to our Web site and, therefore, the integration and timing of any upgrades or enhancements required to facilitate any significant traffic increase to the Web site are uncertain. We have in the past experienced difficulties in upgrading our site infrastructure to handle increased traffic, and these difficulties could recur. The failure to expand and upgrade the Web site or any system error, failure or extended down time, could materially harm our business, reputation, financial condition or results of operations.

Our facilities in the State of California, including our corporate

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headquarters and other critical business operations, are currently subject to electrical blackouts as a consequence of a shortage of available power. In the event these blackouts continue to increase in severity, they could disrupt the operations of our affected facilities and our business could be seriously harmed. In addition, in connection with the shortage of available power, prices for electricity have

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risen dramatically, and will likely to continue to increase in the foreseeable future. Such price changes will increase our operating costs, which could adversely impact our profitability.

THE INTERNET-BASED LEARNING MARKET IS A DEVELOPING MARKET, AND OUR BUSINESS WILL SUFFER IF E-LEARNING IS NOT WIDELY ACCEPTED.

The market for Internet-based enterprise learning is a new and emerging market. Corporate training and education has historically been conducted primarily through classroom instruction and has traditionally been performed by a company's internal personnel. Many companies have invested heavily in their current training solutions. Although technology-based training applications have been available for several years, they currently account for only a small portion of the overall training market.

Accordingly, our future success will depend upon the extent to which companies adopt technology-based solutions and use the Internet in connection with their training activities, and the extent to which companies utilize the services or purchase products of third-party providers. Many companies that have already invested substantial resources in traditional methods of corporate training may be reluctant to adopt a new strategy that may compete with their existing investments. Even if companies implement technology-based training or Internet learning solutions, they may still choose to design, develop, deliver or manage all or part of their education and training internally. If technology based learning and the use of the Internet for learning does not become widespread, or if companies do not use the products and services of third parties to develop, deliver or manage their training needs, then our products and services, may not achieve commercial success.

WE MAY FAIL TO INTEGRATE ADEQUATELY ACQUIRED PRODUCTS, TECHNOLOGIES AND BUSINESSES.

As a result of the consummation of a number of acquisitions our operating expenses have increased. The integration of these businesses may not be successfully completed in a timely fashion, or at all. Further, the revenues from the acquired businesses may not be sufficient to support the costs associated with those businesses, without adversely affecting our operating margins. Any failure to successfully complete the integration in a timely fashion or to generate sufficient revenues from the acquired businesses could have a material adverse effect on our business and results of operations.

In April 2001 we acquired icGlobal, providers of industry acclaimed Learning Management System software. In August 2001 we acquired substantially all of the assets of Impaxselling.com, a sales performance company providing global enterprises with web-based learning solutions designed to improve sales and account management performance. In October 2001 we acquired SkillScape Solutions, Inc., a provider of competency management systems. Difficulties in combining these companies' products and technologies could have an adverse impact on our ability to fully benefit from our existing and future investment in this business and on the future prospects for our business, management and professional education software products.

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We regularly evaluate acquisition opportunities and are likely to make acquisitions in the future that would provide additional product or service offerings, additional industry expertise or an expanded geographic presence. We may be unable to locate attractive opportunities or acquire any that we locate on attractive terms. Future acquisitions could result in potentially dilutive issuances of equity securities, the incurrence of debt and contingent liabilities and amortization expenses related to goodwill and other intangible assets, which could materially adversely affect our results of operations. Product and technology acquisitions entail numerous risks, including difficulties in the assimilation of acquired operations, technologies and products, diversion of management's attention to other business concerns, risks of entering markets in which we have no or limited prior experience and the potential loss of key employees of acquired companies. We may be unable to integrate successfully any operations, personnel or products that have been acquired or that might be acquired in the future and our failure to do so could have a material adverse effect on our results of operations.

RAPID EXPANSION OF OUR OPERATIONS COULD STRAIN OUR PERSONNEL AND SYSTEMS.

We have recently experienced rapid expansion of our operations, which has placed, and is expected to continue to place, significant demands on our executive, administrative, operational and financial personnel and systems. Our future operating results will substantially depend on the ability of our officers and key employees to manage changing business conditions and to implement and improve our operational, financial control and reporting systems. In particular, we require significant improvement in our order entry, fulfillment and management information systems in order to support our expanded operations. If we are unable to respond to and manage changing business conditions, our business and results of operations could be materially adversely affected.

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OUR EXPENSE LEVELS ARE FIXED IN THE SHORT TERM AND WE MAY BE UNABLE TO ADJUST SPENDING TO COMPENSATE FOR UNEXPECTED REVENUE SHORTFALLS.

Our expense levels are based in significant part on our expectations regarding future revenues and are fixed to a large extent in the short term. Accordingly, we may be unable to adjust spending in a timely manner to compensate for any unexpected revenue shortfall. Any significant revenue shortfall would therefore have a material adverse effect on our results of operations. This risk materialized in the third quarter of 1998, where profit was dramatically negatively affected by a shortfall in revenues as against management's expectations.

WE DEPEND ON A FEW KEY PERSONNEL TO MANAGE AND OPERATE US.

Our success is largely dependent on the personal efforts and abilities of our senior management. Failure to retain these executives, or the loss of certain additional senior management personnel or other key employees, could have a material adverse effect on our business and future prospects.

We are also dependent on the continued service of our key sales, content development and operational personnel and on our ability to attract, motivate and retain highly qualified employees. In addition, we depend on writers, programmers, Web designers and graphic artists. We expect to continue to hire additional content development, programmers, sales and marketing, information systems and accounting staff. However, we may be unsuccessful in attracting, retaining or motivating key personnel. The inability to hire and retain qualified personnel or the loss of the services of key personnel could have a material adverse effect upon our current business, new product development

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efforts and future business prospects.

INCREASED COMPETITION MAY RESULT IN DECREASED DEMAND FOR OUR PRODUCTS AND SERVICES, WHICH MAY RESULT IN REDUCED REVENUES AND GROSS MARGINS AND LOSS OF MARKET SHARE.

The market for business education training solutions is highly fragmented and competitive, and we expect this competition to increase. We expect that because of the lack of significant barriers to entry into this market, new competitors may enter the market in the future. In addition to increased competition from new companies entering into the market, established companies are entering into the market through acquisitions of smaller companies, which directly compete with us, and we expect this trend to continue. We expect the market to become increasingly competitive due to the lack of significant barriers to entry. We may also face competition from publishing companies and vendors of application software, including those vendors with whom we have formed development and marketing alliances.

Our primary source of direct competition comes from third-party suppliers of instructor-led information technology, business, management and professional skills education and training as well as suppliers of computer-based training and e-Learning solutions. We also face indirect competition from internal education and training departments of our potential customers. We also compete to a lesser extent with consultants, value-added resellers and network integrators. Certain of these value-added resellers also market products competitive with ours. We expect that as organizations increase their dependence on outside suppliers of training, we will face increasing competition from these other suppliers as education and training managers more frequently compare training products provided by outside suppliers.

Growing competition may result in reduced revenue and gross margins and loss of market share, any one of which have a material adverse effect on our business. Many of our current and potential competitors have substantially greater financial, technical, sales, marketing and other resources, as well as greater name price competition, and we expect that we will face increasing price pressures from competitors as managers demand more value for their training budgets. Accordingly, we may be unable to provide e-Learning solutions that compare favorably with new instructor-led techniques, other interactive training software or new e-Learning solutions or competitive pressures may require us to reduce our prices significantly.

OUR BUSINESS IS SUBJECT TO CURRENCY FLUCTUATIONS THAT CAN ADVERSELY AFFECT OUR OPERATING RESULTS.

Due to our multinational operations, our business is subject to fluctuations based upon changes in the exchange rates between the currencies in which we collect revenues or pay expenses. In particular, the value of the U.S. dollar against the Euro and related currencies impacts our operating results. Our expenses are not necessarily incurred in the currency in which revenue is generated, and, as a result, we are required from time to time to convert currencies to meet our obligations. These currency conversions are subject to exchange rate fluctuations, and changes to the value of the Euro, pound sterling and other currencies relative to the U.S. dollar could adversely affect our business and results of operations.

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OUR CORPORATE TAX RATE MAY INCREASE, WHICH COULD ADVERSELY IMPACT OUR CASH FLOW, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

We have significant operations and generate a majority of our taxable

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income in the Republic of Ireland, and some of our Irish operating subsidiaries are taxed at rates substantially lower than tax rates in effect in the United States and other countries in which we have operations. If our Irish subsidiaries were no longer to qualify for these lower tax rates or if the applicable tax laws were rescinded or changed, our operating results could be materially adversely affected. Moreover, because we incur income tax in several countries, an increase in our profitability in one or more of these countries could result in a higher overall tax rate. In addition, if U.S. or other foreign tax authorities were to change applicable tax laws or successfully challenge the manner in which our subsidiaries' profits are currently recognized, our taxes could increase, and our business, cash flow, financial condition and results of operations could be materially adversely affected.

WE MAY BE UNABLE TO PROTECT OUR PROPRIETARY RIGHTS. UNAUTHORIZED USE OF OUR TECHNOLOGY MAY RESULT IN DEVELOPMENT OF PRODUCTS OR SERVICES THAT COMPETE WITH OURS.

Our success depends on our ability to protect our rights in our intellectual property and trade secrets. We rely upon a combination of copyright, trademark and trade secret laws and customer license agreements, and other methods to protect our proprietary rights. We also enter into confidentiality agreements with our employees, consultants and third parties to seek to limit and protect the distribution of our proprietary information regarding this technology. However, we have not signed protective agreements in every case. Unauthorized parties may copy aspects of our products, services or technology or obtain and use information that we regard as proprietary. Other parties may breach confidentiality agreements and other protective contracts we have executed. We may not become aware of, or have adequate remedies in the event of, a breach. Litigation may be necessary in the future to enforce our intellectual property rights, to protect trade secrets or to determine the validity and scope of the proprietary rights of others. This litigation could result in substantial costs and diversion of management and technical resources.

SOME MAY CLAIM THAT WE INFRINGE THEIR INTELLECTUAL PROPERTY RIGHTS, WHICH COULD RESULT IN COSTLY LITIGATION OR REQUIRE US TO REENGINEER OR CEASE SALES OF OUR PRODUCTS OR SERVICES.

Third parties could in the future claim that our current or future products infringe their intellectual property rights. Any claim, with or without merit, could result in costly litigation or require us to reengineer or cease sales of our products or services, any of which could have a material adverse effect on our business. Infringement claims could also result in an injunction in the use of our products or require us to enter into royalty or licensing agreements. Licensing agreements, if required, may not be available on terms acceptable to us or at all. Though no legal actions are pending at this time, from time to time we learn of parties that claim broad intellectual property rights in the e-Learning area that might implicate our offerings. These parties or others could initiate actions against us in the future.

WE ARE SUBJECT TO A PENDING LEGAL PROCEEDING AND MAY BECOME SUBJECT TO ADDITIONAL PROCEEDINGS AND ADVERSE DETERMINATIONS IN THESE PROCEEDINGS COULD HARM OUR BUSINESS.

Since the end of the third quarter of 1998, a class action lawsuit has been pending in the United States District Court for the Northern District of California against us, one of our subsidiaries, SmartForce USA, and certain of our former and current officers and directors, alleging violation of the federal securities laws. It has been alleged in this lawsuit that we misrepresented or omitted to state material facts regarding our business and financial condition and prospects in order to artificially inflate and maintain the price of our ADSs, and misrepresented or omitted to state material facts in our registration

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statement and prospectus issued in connection with our merger with Forefront, which also is alleged to have artificially inflated the price of our ADSs.

We believe that this action is without merit and intend to vigorously defend ourselves against it. Although we cannot presently determine the outcome of this action, an adverse resolution of this matter could significantly negatively impact our financial position and results of operations.

We may be from time to time involved in various lawsuits and legal proceedings, which arise in the ordinary course of business. An adverse resolution of these matters could significantly negatively impact our financial position and results of operations.

OUR NON-U.S. OPERATIONS ARE SUBJECT TO RISKS WHICH COULD NEGATIVELY IMPACT OUR FUTURE OPERATING RESULTS.

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We expect that international operations will continue to account for a significant portion of our revenues, and intend to continue to expand our operations outside of the United States. Operations outside of the United States are subject to inherent risks, including difficulties or delays in developing and supporting non-English language versions of our products and services, political and economic conditions in various jurisdictions, in staffing and managing foreign subsidiary operations, longer account receivable payment cycles and potential adverse tax consequences. Any of these factors could have a material adverse effect on our future operations outside of the United States, which could negatively impact our future operating results.

BECAUSE MANY USERS OF OUR E-LEARNING SOLUTIONS ACCESS THEM OVER THE INTERNET, FACTORS ADVERSELY AFFECTING THE USE OF THE INTERNET COULD HARM OUR BUSINESS.

Many of our users access our e-Learning solutions over the Internet. Any factors that adversely affect Internet usage could disrupt the ability of those users to access our e-Learning solutions, which would adversely effect customer satisfaction and therefore our business. Factors which could disrupt Internet usage include slow access to download times, security concerns, network problems or service disruptions that prevent users from accessing an Internet server and delays in, or disputes concerning, the development of industry wide Internet standards and protocols.

THE MARKET PRICE FOR OUR ADSS MAY FLUCTUATE AND MAY NOT BE SUSTAINABLE.

The market price of our ADSs has fluctuated significantly since our initial public offering and is likely to continue to be volatile. We believe that factors, such as the following, could cause the price of our ADSs to fluctuate, perhaps substantially:

- announcements of developments related to ourselves or our competitors' business
- announcements of new products or enhancements by ourselves or our competitors
- sales of our ADSs into the public market
- developments in our relationships with our customers, partners and distributors
- shortfalls or changes in revenues, gross margins, earnings or losses or

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other financial results which differ from public market expectations

- changes in the public market expectation of our performance or industry performance
- changes in market valuations of competitors
- regulatory developments
- additions or departures of key personnel
- fluctuations in results of operations and
- general conditions in our market or the markets served by our customers or in the U.S. and or the International economy.

In addition, in recent years the stock market in general, and the market for shares of technology stocks in particular, has experienced extreme price and volume fluctuations, which have often been unrelated to the operating performance of affected companies. The market price of our ADSs may continue to experience significant fluctuations in the future, including fluctuations that are unrelated to our performance.

To succeed we must continue to expand our content offerings, upgrade our technology and distinguish our solution. We may not be able to do successfully. Any failure by us to anticipate or respond adequately to changes in technology and customer preferences or any significant delays in content development or implementation could impact our ability to capture market share.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

Our exposure to market risk for changes in interest rates relate primarily to our investment portfolio. We do not use any derivative financial instruments in our investment portfolio. The primary objective of our investment activities is to preserve capital while maximizing yields without significantly increasing risk. We achieve this by investing our excess cash in deposits with major banks and in U.S. Treasury and U.S. agency obligations and in debt securities of corporations with strong credit ratings All investments are carried at market value, which approximates cost.

The table below presents the principal amount and related weighed average interest rates for our investment portfolio. Our short term investments are all in fixed rate instruments. The principal amounts approximate fair value at September 30, 2001.

TABLE OF CASH AND SHORT TERM INVESTMENTS:

	PRINCIPAL AMOUNT	AVERAGE INTEREST RATE
	-----	-----
SEPTEMBER 30, 2001		
(Dollars in thousands)		

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Cash and cash equivalents	\$ 78,808	2.75%
Short term investments	44,002	3.5%

Total cash and investment securities	\$122,810	
	=====	

FOREIGN CURRENCY RISK

Due to our multinational operations, our business is subject to fluctuations based upon changes in the exchange rates between the currencies in which we collect revenues or pay expenses and the U.S. dollar. Our expenses are not necessarily incurred in the currency in which revenue is generated, and, as a result, we are required from time to time to convert currencies to meet our obligations. These currency conversions are subject to exchange rate fluctuations, in particular changes to the value of the Euro and pound sterling relative to the U.S. dollar, which could adversely affect our business and the results of operations.

At September 30, 2001, we had forward exchange contracts of \$38 million outstanding. All contracts at September 30, 2001 expire at various times throughout 2001 and 2002. Our hedging policy is designed to reduce the impact of foreign currency exchange movements between the Irish pound and U. S. Dollar by hedging identifiable Irish pound denominated commitments. Our accounting policies for these instruments are based on our designation of such instruments as cash flow hedges. We do not use forward currency exchange contracts for speculative trading purposes.

Our outstanding foreign currency forward exchange contracts at September 30, 2001, are presented in the table below. The weighted average exchange rate quoted represents the functional currency to the U.S. dollar.

Functional Currency -----	Amount -----	Expected Maturity Quarter Ended -----	Weighted Average Exchange Rate -----
Irish pounds	\$ 8,000,000	December 31, 2001	1.1707
Irish pounds	\$10,000,000	March 31, 2002	1.0722
Irish pounds	\$10,000,000	June 30, 2002	1.0939
Irish pounds	\$ 5,000,000	September 30, 2002	1.1154
Irish pounds	\$ 5,000,000	December 31, 2002	1.1187

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Since the end of the third quarter of 1998, a class action lawsuit has been pending in United States District Court for the Northern District of against us, one of our subsidiaries, SmartForce USA and certain of our former and current officers and directors alleging violation of the federal securities laws. It has been alleged in this lawsuit that we misrepresented or omitted to state material facts regarding our business and financial condition and prospects in order to

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artificially inflate and maintain the price of our ADSs, and misrepresented or omitted to state material facts in our registration statement and prospectus issued in connection with our merger with ForeFront, which also is alleged to have artificially inflated the price of our ADSs.

We believe that this action is without merit and intend to vigorously defend ourselves against it. Although we cannot presently determine the outcome of this action, an adverse resolution of this matter could significantly negatively impact our financial position and results of operations.

ITEM 2. CHANGES IN SECURITIES

On August 29, 2001 we issued 92,394 ADSs to IMPAXselling.com as consideration for our acquisition of the assets of IMPAXselling.com. On October 11, 2001 we issued 157,654 ADSs to the SkillScape Solutions, Inc., shareholders as part consideration for our acquisition of the outstanding securities of SkillScape Solutions, Inc. The issuance of the ADSs was, exempt from the registration requirements of the Securities Act of 1933, pursuant to Section 4(2) thereof, as the transaction did not involve a public offering.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

3.1 Memorandum of Association of SmartForce PLC

3.2 Articles of Association of SmartForce PLC

10.1 2001 Outside Director Option Plan

10.2 1995 Employee Share Purchase Plan

(b) Reports on Form 8-K

We did not file a report on Form 8-K during the three months ended September 30, 2001.

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SIGNATURE

Pursuant to the requirements 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.

SMARTFORCE PLC

Date: November 14, 2001

By: /s/ Gregory M. Priest

Gregory M. Priest
Chairman of the Board, President and
Chief Executive Officer

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Date: November 14, 2001

By: /s/ David C. Drummond

David C. Drummond
Director, Executive Vice President of
Finance and Chief Financial Officer

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INDEX TO EXHIBITS

- 3.1 Memorandum of Association of SmartForce PLC
- 3.2 Articles of Association of SmartForce PLC
- 10.1 2001 Outside Director Option Plan
- 10.2 1995 Employee Share Purchase Plan