

INTRANET SOLUTIONS INC
Form 10-Q
February 07, 2001
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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Quarterly Period Ended December 31, 2000.

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Transition Period from _____ to _____.

Commission file number 0-19817.

IntraNet Solutions, Inc.

(Exact name of registrant as specified in its charter)

Minnesota

41-1652566

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

7777 Golden Triangle Drive, Eden Prairie,
Minnesota

55344-3736

(Address of principal executive offices)

(Zip Code)

(952) 903-2000

(Registrant's telephone number, including area code)

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 No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. Common Stock, \$.01 par value 21,751,289 shares as of February 5, 2001.

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INTRANET SOLUTIONS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

December 31, 2000	March 31, 2000
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ASSETS

Current assets: Cash and cash equivalents \$7,927 \$8,859 Short-term investments 92,357 124,883 Accounts receivable, net 20,918 7,446 Current maturities of notes receivable 126 126 Inventories 1,088 149 Prepaid royalties 825 1,231 Prepaid expenses and other current assets 1,371 663

Total current

assets 124,612 143,357 Notes receivable, net of current maturities 1,000 Property and equipment, net 3,601 887 Prepaid royalties, net of current portion 2,941 1,644 Intangibles relating to acquisitions 34,383 Deferred income taxes 1,750 Investments in other companies 4,401 833 Other 1,446 594

Total assets \$174,134 \$147,315

LIABILITIES AND SHAREHOLDERS

EQUITY Current liabilities: Current maturities of long-term obligations \$46 \$115 Accounts payable 1,017 2,922 Deferred revenues 5,588 1,433 Commissions payable 1,893 811 Accrued expenses and other 4,331 964

Total current liabilities	12,875,624	Deferred revenues, net of current portion	596,890	Other	111,111
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Total liabilities	13,582,634				
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Shareholders' equity: Common stock, 21,666 and 20,665 shares issued and outstanding, respectively	217,207	Additional paid-in capital	180,839	153,477	Accumulated deficit
	(20,416)	(12,533)	Accumulated comprehensive income	(88)	(181)
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Total shareholders' equity	160,552	140,970			
<hr/>					
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Total liabilities and shareholders' equity	\$174,134	\$147,315			
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See accompanying notes.

Note: The balance sheet at March 31, 2000 has been derived from audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.

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**INTRANET SOLUTIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(Unaudited)**

		Three Months Ended December 31,	Nine Months Ended December 31,
2000	1999	2000	1999
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REVENUES:

Product licenses\$15,903\$4,671\$36,097\$11,695Services3,6331,1598,5233,156

Total revenues19,5365,83044,62014,851

COST OF REVENUES:Product

licenses1,1315102,6301,235Services1,9385684,6471,533

Total cost of revenues3,0691,0787,2772,768

Gross profit16,4674,75237,34312,083

OPERATING EXPENSES:Sales and marketing8,5642,74119,3656,736General and administrative2,5881,0526,3322,829Research and development2,7837316,4891,879Acquisition and related costs185 7751,972Amortization of acquired intangible assets and other3,381 7,010 Write-off of in-process research and development 10,400

Total operating expenses17,5014,52450,37113,416

Income (loss) from operations(1,034)228(13,028)(1,333) Other:Interest income, net1,5773805,546774Other expense(400) (400)

Net income (loss)\$143\$608\$(7,882)\$(559)

Net income (loss) per common
share:Basic\$0.01\$0.04\$(0.37)\$(0.04)Diluted\$0.01\$0.03\$(0.37)\$(0.04) Weighted
average common shares
outstanding:Basic21,55217,12321,35915,859Diluted23,84919,60821,35915,859

See accompanying notes.

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**INTRANET SOLUTIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)**

	Nine Months Ended December 31,	
	2000	1999
Operating activities:		
Net loss\$(7,882)\$(559)Adjustments to reconcile net loss to cash provided by operating activities:Depreciation and amortization1,154531Write-off of in-process research and development10,400 Amortization of acquired intangible assets and other7,010 Other(1,740)87Tax benefit from employee stock option exercises(1,750) Changes in operating assets and liabilities, net of amounts acquired:Accounts receivable, net(7,506)(2,240)Prepaid expenses(1,015)(61)Inventories(330)(105)Accounts payable(2,569)(119)Accrued liabilities2,391116Deferred revenue(640) Accrued commissions1,082 Income taxes payable1,750		
Net cash provided by (used in) operating activities355(2,350)		

Investing activities: Maturities and (purchases) of short-term investments, net 32,526 (25,224) Purchase of property and equipment (1,760) (946) Acquisitions, net of cash acquired (54,521) Purchase of long-term investments (1,735) (513) Notes receivable advances (1,018) Other (3) 71

Net cash used in investing activities (26,511) (26,612)

Financing activities: Net repayments of revolving credit facility (422) Payments on long-term debt obligations (150) (650) Proceeds from long-term obligations 100 Issuance of common stock, net of offering expenses 22,708 26,956 Proceeds from exercise of stock options and warrants 2,691 4,761 Other (25) 44

Net cash provided by financing activities 25,224 30,789

Net increase (decrease) in cash (932) 1,827 Cash and cash equivalents, beginning of period 8,859 2,177

Cash and cash equivalents, end of period \$7,927 \$4,004

See accompanying notes.

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INTRANET SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands)

1. NATURE OF THE BUSINESS

IntraNet Solutions, Inc., (the Company) is a leading provider of business content management solutions, including mobile and wireless access for intranet, extranet and Internet applications that offer customers the ability to rapidly access, manage and publish business data. IntraNet Solutions Xpedio Content Management System is the industry's first single source, end-to-end content management solution. The Company's customers are primarily located throughout the United States and in Europe.

2. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with Regulation S-X pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although management believes that the disclosures are adequate to make the information presented not misleading.

In the opinion of management, the unaudited condensed consolidated financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position as of December 31, 2000 and March 31, 2000 and the results of operations for the three and nine months ended December 31, 2000 and 1999 and cash flows for the nine months ended December 31, 2000 and 1999. The results of operations for the three and nine months ended December 31, 2000 are not necessarily indicative of the results for the full year.

Principles of Consolidation: The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany transactions and balances have been eliminated. See note 5 for a discussion of recent acquisitions.

Revenue Recognition: The Company currently derives all of its revenues from licenses of its suite of products and related services. Product license revenue is recognized when evidence of a purchase arrangement exists, the product has been shipped, the fee is determinable and collectible, and no significant obligations remain related to implementation. Technical services and support revenue consists of fees from consulting and maintenance. Consulting services include needs assessment, software integration, security analysis, application development and training. The Company's clients typically purchase maintenance agreements annually, and the Company prices maintenance agreements based on a percentage of the product license fee. Customers purchasing maintenance agreements receive product upgrades, Web-based technical support and telephone hot-line support. The Company recognizes revenue from maintenance agreements ratably over the term of the agreement, typically one year. Customer advances and billed amounts due from customers in excess of revenue recognized are recorded as deferred revenue.

Cash and Equivalents: The Company considers all short-term, highly liquid investments that are readily convertible into known amounts of cash and have original maturities of three months or less to be cash equivalents.

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Short-term Investments: Investments in debt securities with a remaining maturity of three months or greater are classified as short-term investments. Management determines the appropriate classification of debt securities at the time of purchase and reevaluates such designation as of each balance sheet date. The book value of the investments approximates their estimated market value. As of December 31, 2000 the Company's investments were in commercial paper and U.S. Government Agency securities. All investments have a contractual maturity of six months or less and are held to maturity.

Reclassifications: Certain reclassifications have been made to the three and nine month periods ending December 31, 1999 to conform with the presentation used in the December 31, 2000 financial statements. The reclassifications did not effect net income or shareholders' equity as previously reported.

3. NET INCOME (LOSS) PER COMMON SHARE

The Company's basic net income (loss) per share amounts have been computed by dividing net income (loss) by the weighted average number of outstanding common shares. The Company's diluted net income (loss) per share is computed by dividing net income (loss) by the weighted average number of outstanding common shares and common share equivalents relating to options and warrants, when dilutive. As a result of the Company's net loss in the nine months ended December 31, 2000 and 1999, all of the Company's stock options and warrants were anti-dilutive.

4. SHAREHOLDERS' EQUITY

Common stock offering: The Company consummated a common stock offering on June 3, 1999, consisting of 3,230 shares of common stock at an \$8.00 per share price to the public. The net proceeds of the Offering, after underwriting discounts, commissions and offering costs of approximately \$2,300, was approximately \$23,500. In July 1999, the underwriters exercised their 15% over-allotment, resulting in the sale of an additional 485 shares of common stock. The net proceeds from the exercise of the over-allotment were approximately \$3,400.

On March 9, 2000, the Company completed a secondary offering of 2,305 shares of its common stock and received net proceeds of approximately \$100,000. The proceeds from both offerings will be used for working capital and general corporate purposes. On April 10, 2000, 520 shares of the underwriters' over allotment option from the Company's March 9, 2000 secondary offering were issued for net proceeds of approximately \$22,729.

5. ACQUISITIONS

On September 29, 1999, the Company completed its acquisition of InfoAccess, Inc. (InfoAccess), using the pooling-of-interests method of accounting. Each share of InfoAccess common stock outstanding at the time of the merger was converted into the right to receive 0.31230 shares of common stock of the Company in accordance with the merger agreement. An aggregate of 1,803 shares of common stock of the Company were issued in exchange for the 5,775 shares of common stock of InfoAccess outstanding at the time of the acquisition. In addition, the Company converted 1,207 outstanding options to purchase InfoAccess common stock into 377 options to acquire the Company's common stock, on substantially the same terms as the original option agreement.

On July 10, 2000, the Company acquired the Information Exchange Division (IED) of Inso Corporation (Inso). This transaction was accounted for under the purchase method of accounting and the acquired net assets were recorded at their estimated fair values at the date of acquisition. The total cost of the acquisition, including transaction costs, was approximately \$55.3 million. The following table presents the allocation of the purchase price:

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In-process research and development	\$ 10,400
Core technology	13,200
Customer base	3,500
Workforce	3,000
Capitalized software	2,800
Trademarks	1,700
Non-compete provisions	1,400
Excess of cost over fair value of net assets acquired	15,212
Net fair value of tangible assets acquired and liabilities assumed	4,058
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Purchase price	\$55,270
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The amounts allocated to core technology, customer base, workforce, capitalized software, trademarks and other intangibles are being amortized over the assets' estimated useful life of three years. Similarly, the excess of cost over fair value of net assets acquired is being amortized over the assets' estimated useful life of three years.

The values assigned to in-process research and development were expensed at the date of acquisition, since technological feasibility had not been established. The following unaudited pro forma statement of operations information was prepared assuming the IED acquisition had occurred on April 1, 1999 and in process research and development had been expensed as of that date:

	Nine Months Ended December 31,	
	2000	1999
Total revenues	\$ 50,480	\$ 23,146
In process research and development (10,400)		
Net income	759	(12,141)
Net income (loss) per share: Basic	\$0.04	\$(0.77)
Diluted	\$0.03	\$(0.77)
Weighted-average shares outstanding: Basic	21,359	15,859
Diluted	23,499	15,859

6. INCOME TAXES

In the three months ended December 31, 2000, the Company recorded a deferred tax asset of \$1,750 primarily related to the amortization of intangibles. As the Company believes that it is more likely than not that this asset will be realized, no valuation allowance has been recorded against this portion of the Company's deferred tax asset. Additionally, during the three months ended December 31, 2000 the Company reduced current income taxes payable by \$1,750 as a result of deductions related to stock option exercises. The effect of this reduction has been added to additional paid-in capital.

Table of Contents**PART I FINANCIAL INFORMATION****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Forward-Looking Statements**

The information presented in this Item contains forward-looking statements within the meaning of the safe harbor provisions of Section 21E of the Securities Exchange Act of 1934, as amended. Such statements are subject to risks and uncertainties, including those discussed under Risk Factors below, that could cause actual results to differ materially from those projected. Because actual results may differ, readers are cautioned not to place undue reliance on these forward-looking statements.

Overview

IntraNet Solutions, Inc., (the "Company") is a leading provider of business content management solutions, including mobile and wireless access for intranet, extranet and Internet applications that offer customers the ability to rapidly access, manage and publish business data. IntraNet Solutions' Xpedio Content Management System is the industry's first single source, end-to-end content management solution. The Company's customers are primarily located throughout the United States and Europe.

We currently derive all of our revenues from licenses of our software products and related services. Product license revenue is recognized when evidence of a purchase arrangement exists, the product has been shipped, the fee is determinable and collectible, and no significant obligations remain related to implementation. Revenues for technical services and support consist of fees from consulting and maintenance. Consulting services include needs assessment, software integration, security analysis, application development and training. Our clients typically purchase annual maintenance agreements, and we price maintenance agreements based on a percentage of the product license fee. Clients purchasing maintenance agreements receive product upgrades, Web-based technical support and telephone hot-line support. We recognize revenues from maintenance agreements ratably over the term of the agreement, typically one year.

Cost of revenues consists of technology royalties, costs to manufacture, package and distribute our products and related documentation, as well as personnel and other expenses related to providing services. Sales and marketing expenses consist primarily of employee salaries, commissions, and costs associated with marketing programs such as advertising, public relations and trade shows. Research and development expenses consist primarily of salaries and related costs associated with the development of new products, the enhancement of existing products and the performance of quality assurance and documentation activities. General and administrative expenses consist primarily of salaries and other personnel-related costs for executive, financial, human resources, information services and other administrative personnel, as well as legal, accounting, insurance costs and provisions for doubtful accounts.

Since our inception, we have incurred substantial costs to develop our technology and products, to recruit and train personnel for our sales and marketing, research and development and services departments, to establish an administrative organization and for intangibles related to acquisitions. As a result, we have an accumulated deficit of approximately \$20.4 million at December 31, 2000. We anticipate that our operating expenses will increase substantially in future quarters as we increase sales and marketing operations, develop new distribution channels, fund greater levels of research and development, broaden services, improve operational and financial systems and continue to consider acquisitions. In addition, our limited operating history makes it difficult for us to predict future operating results. We cannot be certain that we will sustain revenue growth or profitability.

On July 10, 2000, we acquired the Information Exchange Division (IED) of Inso Corporation. IED is a market leader in mobile and wireless device viewing technologies and wireless business-to-business and business-to-employee applications and Web conversion. IED provides viewing technology for the Windows CE and Symbian operating systems that allows users of these mobile and wireless devices to readily view files from desktop applications. Additionally, IED's products provide conversion of over 225 different file types to Web formats including XML, HTML or Wireless Markup Language (WML). The total cost of the acquisition, including transaction costs, was approximately \$55.3 million.

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The acquisition was accounted for as a purchase business combination. Accordingly, the net fair value of tangible and intangible assets acquired and liabilities assumed were recorded at their estimated fair values at the effective date of the acquisition and the results of operations of IED are included with those of the Company for the periods subsequent to the date of the acquisition.

Results of Operations Three Months Ended December 31, 2000 Compared to Three Months Ended December 31, 1999***Revenues***

Total revenues increased by \$13.7 million, or 235%, to \$19.5 million for the three months ended December 31, 2000 from \$5.8 million for the three months ended December 31, 1999. The increase in revenues was attributable to internal expansion of our customer base, increased sales to existing customers and the customer base derived from IED.

Product Licenses. Revenues for product licenses increased by \$11.2 million, or 240% to \$15.9 million for the three months ended December 31, 2000 from \$4.7 million for the three months ended December 31, 1999. The increase in revenues for product licenses was attributable to the internal expansion of our customer base, increased sales to existing customers and the customer base derived from IED.

Services. Revenues for services increased by \$2.5 million or 213% to \$3.6 million for the three months ended December 31, 2000 from \$1.1 million for the three months ended December 31, 1999. The increase in revenues for services was primarily attributable to a larger installed base of products.

Cost of Revenues and Gross Profit

Total cost of revenues increased by \$2.0 million or 185% to \$3.1 million for the three months ended December 31, 2000 from \$1.1 million for the three months ended December 31, 1999. Total cost of revenues as a percentage of total revenues was 16% for the three months ended December 31, 2000 compared to 18% for the three months ended December 31, 1999. Gross profit increased by \$11.7 million, or 247%, to \$16.5 million for the three months ended December 31, 2000 from \$4.8 million for the three months ended December 31, 1999. Total gross profit as a percentage of total revenues was 84% for the three months ended December 31, 2000 compared to 82% for the three months ended December 31, 1999. The increase in gross profit was due to increased revenues.

Product Licenses. Cost of revenues for product licenses increased by \$0.6 million, or 122%, to \$1.1 million for the three months ended December 31, 2000 from \$0.5 million for the three months ended December 31, 1999. Gross profit as a percentage of revenues for product licenses was 93% for the three months ended December 31, 2000 and 89% for the three months ended December 31, 1999. The change in gross profit percentage is due primarily to increased sales of our Xpedio Content Management Suite, content conversion and viewing products, which typically have higher sales prices than our other products.

Services. Cost of revenues for services increased by \$1.3 million or 241%, to \$1.9 million for the three months ended December 31, 2000 from \$0.6 million for the three months ended December 31, 1999. Gross profit as a percentage of revenues for services was 47% for the three months ended December 31, 2000 and 51% for the three months ended December 31, 1999. The change in gross profit percentage is due primarily to increased recruiting and staffing costs associated with consulting services personnel.

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Sales and Marketing. Sales and marketing expenses increased by \$5.9 million, or 212%, to \$8.6 million for the three months ended December 31, 2000 from \$2.7 million for the three months ended December 31, 1999. Sales and marketing expenses as a percentage of total revenues were 44% for the three months ended December 31, 2000 compared to 47% for the three months ended December 31, 1999. The increase in sales and marketing expenses was primarily due to the personnel added by the acquisition of IED. The decrease in sales and marketing expense as a percentage of revenues was primarily due to the increase in revenues.

General and Administrative. General and administrative expenses increased by \$1.5 million or 146%, to \$2.6 million for the three months ended December 31, 2000 from \$1.1 million for the three months ended December 31, 1999. General and administrative expenses as a percentage of total revenues were 13% for the three months ended December 31, 2000 compared to 18% for the three months ended December 31, 1999. General and administrative expenses decreased as a percentage of revenues due primarily to an increase in total revenues partially offset by an increase in personnel expenses.

Research and Development. Research and development expenses increased by \$2.1 million, or 281%, to \$2.8 million for the three months ended December 31, 2000 from \$0.7 million for the three months ended December 31, 1999. Research and development expenses as a percentage of total revenues were 14% for the three months ended December 31, 2000 compared to 13% for the three months ended December 31, 1999. The increase in research and development expenses as a percentage of total revenues was primarily due to an increase in staffing related to the personnel added by the acquisition of IED, and related costs to support new products and product enhancements.

Amortization of Intangibles. A portion of the purchase price of IED was allocated to excess cost over fair value of net assets acquired, core technology, customer base, software, trademarks and other intangibles, and will be amortized over the assets' estimated useful lives, of three years. Intangible amortization expense resulting from the acquisition was \$3.4 million for the three month period ended December 31, 2000.

Other Income/Expense

Net interest income was \$1.6 million for the three months ended December 31, 2000 compared to net interest income of \$0.4 million for the three months ended December 31, 1999. Net interest income for the three months ended December 31, 2000 and 1999 was primarily related to short-term investments purchased with the proceeds of our public stock offerings completed in June 1999 and March 2000. Other expenses of \$0.4 million for the three months ended December 31, 2000 related to the permanent decline in the value of an investment the Company made in fiscal year 2000.

Results of Operations Nine months Ended December 31, 2000 Compared to Nine months Ended December 31, 1999***Revenues***

Total revenues increased by \$29.8 million, or 200%, to \$44.6 million for the nine months ended December 31, 2000 from \$14.8 million for the nine months ended December 31, 1999. The increase in revenues was attributable to internal expansion of our customer base, increased sales to existing customers and the customer base acquired from

IED.

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Product Licenses. Revenues for product licenses increased by \$24.4 million, or 209%, to \$36.1 million for the nine months ended December 31, 2000 from \$11.7 million for the nine months ended December 31, 1999. The increase in revenues for product licenses was attributable to internal expansion of our customer base, increased sales to existing customers and the customer base acquired from IED.

Services. Revenues for services increased by \$5.4 million or 170%, to \$8.5 million for the nine months ended December 31, 2000 from \$3.1 million for the nine months ended December 31, 1999. The increase in revenues for services was primarily attributable to a larger installed base of products.

Cost of Revenues and Gross Profit

Total cost of revenues increased by \$4.5 million or 163%, to \$7.3 million for the nine months ended December 31, 2000 from \$2.8 million for the nine months ended December 31, 1999. Total cost of revenues as a percentage of total revenues was 16% for the nine months ended December 31, 2000 compared to 19% for the nine months ended December 31, 1999. Gross profit increased by \$25.2 million, or 209%, to \$37.3 million for the nine months ended December 31, 2000 from \$12.1 million for the nine months ended December 31, 1999. Total gross profit as a percentage of total revenues was 84% for the nine months ended December 31, 2000 compared to 81% for the nine months ended December 31, 1999. The increase in gross profit percentage and dollars was primarily due to increased revenues for product licenses and services.

Product Licenses. Cost of revenues for product licenses increased by \$1.4 million or 113%, to \$2.6 million for the nine months ended December 31, 2000 from \$1.2 million for the nine months ended December 31, 1999. Gross profit as a percentage of revenues for product licenses was 93% for the nine months ended December 31, 2000 and 89% for the nine months ended December 31, 1999. The change in gross profit percentage is due primarily to increased sales of our Xpedio Content Management Suite and content conversion and viewing products, which typically have higher sales prices than our other products.

Services. Cost of revenues for services increased by \$3.1 million, or 203%, to \$4.6 million for the nine months ended December 31, 2000 from \$1.5 million for the nine months ended December 31, 1999. Gross profit as a percentage of revenues for services was 45% for the nine months ended December 31, 2000 compared to 51% for the nine months ended December 31, 1999. The decrease in the gross profit as a percentage of revenues for services was primarily due to increased recruiting and staffing costs for consulting services personnel.

Operating Expenses

Sales and Marketing. Sales and marketing expenses increased by \$12.6 million, or 187%, to \$19.3 million for the nine months ended December 31, 2000 from \$6.7 million for the nine months ended December 31, 1999. Sales and marketing expenses as a percentage of total revenues were 43% for the nine months ended December 31, 2000 compared to 45% for the nine months ended December 31, 1999. The increase in sales and marketing expense was primarily due to increased staffing and marketing expenses for advertising, branding, public relations and trade shows and the inclusion of sales and marketing expenses of IED.

General and Administrative. General and administrative expenses increased by \$3.5 million or 124%, to \$6.3 million for the nine months ended December 31, 2000 from \$2.8 million for the nine months ended

December 31, 1999. General and administrative expenses as a percentage of total revenues were 14% for the nine months ended December 31, 2000 compared to 19% for the nine months ended December 31, 1999. General and administrative expenses decreased as a percentage of revenues due primarily to an increase in total revenues partially offset by an increase in personnel expenses.

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Research and Development. Research and development expenses increased by \$4.6 million, or 245%, to \$6.5 million for the nine months ended December 31, 2000 from \$1.9 million for the nine months ended December 31, 1999. Research and development expenses as a percentage of total revenues were 15% for the nine months ended December 31, 2000 compared to 13% for the nine months ended December 31, 1999. The increase in research and development expenses as a percentage of total revenues was primarily due to increases in staffing and related costs to support new products and product enhancements, and the acquisition of IED.

Purchased In-process Research and Development and Acquisition-Related Charges. In connection with our acquisitions, primarily IED, we incurred certain costs. A portion of the purchase price, \$10.4 million, was allocated to in-process research and development and was expensed.

Amortization of Intangibles. A portion of the purchase price of IED was allocated to excess cost over fair value of net assets acquired, core technology, customer base, software, trademarks and other intangibles, and will be amortized over the assets' estimated useful lives of three years. Intangible amortization expense resulting from the acquisition was \$7.0 million for the nine month period ended December 31, 2000.

Other Income/Expense

Net interest income was \$5.5 million for the nine months ended December 31, 2000 compared to net interest income of \$0.8 million for the nine months ended December 31, 1999. Net interest income for the nine months ended December 31, 2000 and 1999 was primarily related to short-term investments purchased with the proceeds of our public stock offerings completed in June 1999 and March 2000. Other expenses of \$0.4 million for the nine months ended December 31, 2000 related to the permanent decline in the value of an investment the Company made in fiscal year 2000.

Net Operating Loss Carryforwards

As of March 31, 2000, we had net operating loss carryforwards of approximately \$35.7 million. The net operating loss carryforwards will expire at various dates beginning in 2011, if not utilized. The Tax Reform Act of 1986 imposes substantial restrictions on the utilization of net operating losses and tax credits in the event of an ownership change of a corporation. Our ability to utilize net operating loss carryforwards on an annual basis will be limited as a result of ownership changes in connection with the sale of equity securities. We have provided a valuation allowance on a portion of the deferred tax asset because of the uncertainty regarding its realization.

Liquidity and Capital Resources

We have funded our operations and satisfied our capital expenditure requirements primarily through operating revenues, revolving working capital and term loans from banking institutions, private placements and public offerings of securities and proceeds from the sales of assets related to prior lines of business. Net cash provided by operating activities was \$0.4 million for the nine months ended December 31, 2000, compared to net cash used in operating activities of \$2.4 million for the nine months ended December 31, 1999.

To date, we have invested our capital expenditures primarily in property and equipment, consisting largely of computer hardware and software. Capital expenditures for the nine months ended December 31, 2000 and 1999 were \$1.8 million and \$1.0 million, respectively. We have also entered into capital and operating leases for facilities and equipment. We expect that our capital expenditures will increase as our employee base grows.

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As of December 31, 2000, we had \$7.9 million in cash and equivalents, \$92.4 million in short-term investments and \$111.7 million in working capital. Net cash provided by financing activities was \$25.2 million for the nine months ended December 31, 2000 and \$30.8 million for the nine months ended December 31, 1999. In June 1999, we completed a public offering of our common stock that raised approximately \$27.0 million in proceeds for the Company, net of underwriting discounts and offering costs of approximately \$3.0 million. In March 2000, we completed a public offering of our common stock that raised approximately \$100 million in proceeds for the Company, net of underwriting discounts and offering costs of approximately \$5.9 million. In April 2000, the underwriters exercised their over-allotment option, raising additional net proceeds of approximately \$22.7 million.

We currently believe that the cash and cash equivalents on hand will be sufficient to meet our working capital requirements for the foreseeable future. After that time, we may require additional funds to support our working capital requirements or for other purposes and may seek to raise such additional funds through public or private equity financings or from other sources. We cannot be certain that additional financing will be available on terms favorable to us, or on any terms, or that any additional financing will not be dilutive.

The Company continues to evaluate potential strategic acquisitions that could utilize equity and, or, cash resources. Such opportunities could develop quickly due to market and competitive factors.

PRO FORMA NET INCOME PER COMMON SHARE

The Company's pro forma basic net income per share is computed by dividing pro forma net income by the weighted average number of outstanding common shares and the Company's pro forma diluted net income per share is computed by dividing pro forma net income by the weighted average number of outstanding common shares and common share equivalents relating to stock options and warrants, when dilutive. Common stock equivalent shares consist of stock options and warrants (using the treasury stock method). The accompanying pro forma supplemental financial information is presented for informational purposes only and is not a substitute for the historical financial information presented in accordance with accounting principles generally accepted in the United States.

	Three Months Ended December 31,		Nine months Ended December 31,	
	2000	1999	2000	1999
SUPPLEMENTAL INFORMATION				
Net income (loss)	\$143	\$608	\$(7,882)	\$(559)
Add back charges: Amortization of intangible assets and other	3,381	7,010	Write-off	
of in-process research and development	10,400	Acquisition and related		
costs	185	7751,972		

Total add back 3,566 18,185,972

Pro forma net income \$3,709 \$608 \$10,303 \$1,413

Pro forma net income per
share: Basic \$0.17 \$0.04 \$0.48 \$0.09 Diluted \$0.16 \$0.03 \$0.44 \$0.08 Weighted average
common shares
outstanding: Basic 21,552 17,123 21,359 15,859 Diluted 23,849 19,608 23,499 17,873

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RISK FACTORS

Disclosure Regarding Forward-Looking Statements

This Form 10-Q for the quarter ended December 31, 2000 contains certain forward looking statements within the meaning of Section 21E of the Exchange Act. Such forward-looking statements are based on the beliefs of the Company's management as well as on assumptions made by and information currently available to the Company at the time such statements were made. When used in this Form 10-Q, the words "anticipate", "believe", "estimate", "expect", "intend", and similar expressions, as they relate to the Company, are intended to identify such forward-looking statements. Although the Company believes these statements are reasonable, readers of this Form 10-Q should be aware that actual results could differ materially from those projected by such forward-looking statements as a result of the risk factors listed below and set forth in the Company's Annual Report on Form 10-K for 2000 ("Form 10-K") under the caption "Risk Factors". Readers of this Form 10-Q should consider carefully the factors listed below and under the caption "Risk Factors" in the Company's Form 10-K, as well as the other information and data contained in this Form 10-Q. The Company cautions the reader, however, that such list of factors under the caption "Risk Factors" in the Company's Form 10-K may not be exhaustive and that those or other factors, many of which are outside of the Company's control, could have a material adverse effect on the Company and its results of operations. All forward-looking statements attributable to the Company or persons acting on its behalf are expressly qualified in their entirety by the cautionary statements set forth hereunder and under the caption "Risk Factors" in the Company's Form 10-K. We undertake no obligation to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

OUR SUCCESS DEPENDS ON OUR ABILITY TO SUCCESSFULLY INTEGRATE IED WITH OUR OPERATIONS.

On July 10, 2000, we acquired IED from eBT Technologies, Inc. (formerly INSO Corporation) in a transaction accounted for under the purchase method of accounting. We are currently integrating the business and products of IED without existing business and products. We may incur unanticipated costs in the course of this integration. In addition, the integration of IED with our operations involves the following risks:

failure to develop complementary product offerings and marketing strategies;

failure to maintain the customer relationships of IED;

failure to retain the employees of IED;

failure to coordinate product development efforts; and

diversion of management's time and attention from other aspects of our business.

We cannot be sure that we will be successful in integrating the business and products of IED with our business and products. If we are not, our business, operating results and financial condition may be materially adversely affected.

FLUCTUATIONS IN OUR OPERATING RESULTS MAY MAKE IT DIFFICULT TO PREDICT OUR FUTURE PERFORMANCE.

While our products and services are not seasonal, our revenues and operating results are difficult to predict and may fluctuate significantly from quarter to quarter. If our quarterly revenues or operating results fall below the expectations of investors or securities analysts, the price of our common stock

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could fall substantially. A large part of our sales typically occur in the last month of a quarter. If these sales were delayed from one quarter to the next for any reason, our operating results could fluctuate dramatically. In addition, our sales cycles may vary, making the timing of sales difficult to predict. Furthermore, our infrastructure costs are generally fixed. As a result, modest fluctuations in revenues between quarters may cause large fluctuations in operating results. These factors all tend to make the timing of revenues unpredictable and may lead to high period-to-period fluctuations in operating results.

Our quarterly revenues and operating results may fluctuate for several additional reasons, many of which are outside of our control, including the following:

demand for our products and services;