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EXTENSITY INC  
Form 10-Q  
August 14, 2002

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

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended June 30, 2002

or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission file number: 000-28897

EXTENSITY, INC.  
(Exact name of Registrant as specified in its charter)

DELAWARE  
(State or other jurisdiction of incorporation or organization)

68-0368868  
(IRS Employer Identification Number)

2200 POWELL STREET, SUITE 300, EMERYVILLE, CALIFORNIA 94608  
(Address of principal executive offices and zip code)

(510) 594-5700  
(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

The number of shares of the Registrant's Common Stock outstanding as of July 31, 2002 was 25,195,813.

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### PART I. FINANCIAL INFORMATION

|                                                                 |
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| ITEM 1. Condensed Consolidated Financial Statements (Unaudited) |
|-----------------------------------------------------------------|

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

#### ASSETS

|                                  | June 30,<br>2002<br>----- | Decembe<br>200<br>----- |
|----------------------------------|---------------------------|-------------------------|
| Current assets:                  |                           |                         |
| Cash and cash equivalents        | \$ 4,816                  | \$ 19,                  |
| Short-term investments           | 33,998                    | 26,                     |
| Accounts receivable, net         | 3,740                     | 5,                      |
| Prepaid and other current assets | 1,466                     | 1,                      |
|                                  | -----                     | -----                   |
| Total current assets             | 44,020                    | 53,                     |
| Property and equipment, net      | 3,014                     | 3,                      |
| Restricted long-term investments | 1,397                     | 1,                      |
| Other assets                     | 367                       |                         |
|                                  | -----                     | -----                   |
| Total assets                     | \$ 48,798<br>=====        | \$ 59,<br>=====         |

#### LIABILITIES AND STOCKHOLDERS' EQUITY

|                      |          |       |
|----------------------|----------|-------|
| Current liabilities: |          |       |
| Accounts payable     | \$ 3,451 | \$ 3, |
| Accrued liabilities  | 3,281    | 3,    |

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|                                                        |           |        |
|--------------------------------------------------------|-----------|--------|
| Deferred revenue                                       | 3,182     | 3,     |
| Capital lease obligations                              | 167       |        |
| Sublease loss accrual                                  | 383       |        |
|                                                        | -----     | -----  |
| Total current liabilities                              | 10,464    | 12,    |
| Capital lease obligations                              | --        |        |
| Sublease loss accrual and other noncurrent liabilities | 1,849     |        |
|                                                        | -----     | -----  |
| Total liabilities                                      | 12,313    | 13,    |
|                                                        | -----     | -----  |
| Stockholders' equity:                                  |           |        |
| Common stock                                           | 25        |        |
| Additional paid-in capital                             | 147,334   | 147,   |
| Deferred stock compensation                            | (94)      | (      |
| Notes receivable from stockholders                     | (446)     | (      |
| Accumulated comprehensive income                       | 192       |        |
| Accumulated deficit                                    | (110,526) | (100,  |
|                                                        | -----     | -----  |
| Total stockholders' equity                             | 36,485    | 46,    |
|                                                        | -----     | -----  |
| Total liabilities and stockholders' equity             | \$ 48,798 | \$ 59, |
|                                                        | =====     | =====  |

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

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EXTENSITY, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(In thousands, except per share data)  
(Unaudited)

|                         | Three Months Ended<br>June 30, |          | Six M<br>J |
|-------------------------|--------------------------------|----------|------------|
|                         | 2002                           | 2001     | 2002       |
|                         | -----                          | -----    | -----      |
| Revenues:               |                                |          |            |
| License                 | \$ 1,743                       | \$ 5,651 | \$ 2,949   |
| Service and maintenance | 3,074                          | 3,480    | 6,197      |
| Hosted                  | 194                            | --       | 388        |
|                         | -----                          | -----    | -----      |
| Total revenues          | 5,011                          | 9,131    | 9,534      |
|                         | -----                          | -----    | -----      |
| Cost of revenues: (*)   |                                |          |            |
| Licenses                | 144                            | 263      | 249        |
| Service and maintenance | 1,843                          | 3,444    | 4,247      |
| Hosted                  | 340                            | --       | 606        |
|                         | -----                          | -----    | -----      |
| Total cost of revenues  | 2,327                          | 3,707    | 5,102      |
|                         | -----                          | -----    | -----      |
| Gross profit            | 2,684                          | 5,424    | 4,432      |
|                         | -----                          | -----    | -----      |

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|                                                                   |            |            |             |
|-------------------------------------------------------------------|------------|------------|-------------|
| Operating expenses: (*)                                           |            |            |             |
| Sales and marketing                                               | 2,894      | 7,043      | 6,410       |
| Research and development                                          | 1,830      | 3,945      | 3,934       |
| General and administrative                                        | 1,472      | 1,856      | 2,965       |
| Restructuring and other non-recurring charges                     | 1,695      | --         | 1,695       |
|                                                                   | -----      | -----      | -----       |
| Total operating expenses                                          | 7,891      | 12,844     | 15,004      |
|                                                                   | -----      | -----      | -----       |
| Loss from operations                                              | (5,207)    | (7,420)    | (10,572)    |
| Interest income, net                                              | 220        | 687        | 490         |
|                                                                   | -----      | -----      | -----       |
| Net loss                                                          | \$ (4,987) | \$ (6,733) | \$ (10,082) |
|                                                                   | =====      | =====      | =====       |
| Basic and diluted net loss per share                              | \$ (0.20)  | \$ (0.28)  | \$ (0.41)   |
| Shares used in computing basic and diluted net loss per share     | 24,818     | 23,735     | 24,676      |
| (*) Amounts include non-cash stock based compensation as follows: |            |            |             |
| Cost of revenues:                                                 |            |            |             |
| Service and maintenance                                           | \$ --      | \$ 9       | \$ 3        |
| Operating expenses:                                               |            |            |             |
| Sales and marketing                                               | --         | 18         | 7           |
| Research and development                                          | --         | 11         | 4           |
| General and administrative                                        | --         | 17         | 7           |
|                                                                   | -----      | -----      | -----       |
|                                                                   | \$ --      | \$ 55      | \$ 21       |
|                                                                   | =====      | =====      | =====       |

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

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EXTENSITY, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands)  
(Unaudited)

|                                                                         | Six Months Ended<br>June 30, |    |
|-------------------------------------------------------------------------|------------------------------|----|
|                                                                         | -----                        |    |
|                                                                         | 2002                         |    |
|                                                                         | -----                        |    |
| Cash flows from operating activities:                                   |                              |    |
| Net loss                                                                | \$ (10,082)                  | \$ |
| Adjustments to reconcile net loss to cash used in operating activities: |                              |    |
| Depreciation and amortization                                           | 850                          |    |
| Amortization of deferred stock compensation and other                   | 35                           |    |
| Amortization of debt discount and lease line issuance costs             | 4                            |    |
| Interest earned on notes from stockholders                              | (13)                         |    |
| Changes in operating assets and liabilities:                            |                              |    |

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|                                                      |          |
|------------------------------------------------------|----------|
| Accounts receivable                                  | 1,653    |
| Prepays and other current assets                     | 369      |
| Other assets                                         | 234      |
| Accounts payable                                     | (221)    |
| Accrued liabilities                                  | (696)    |
| Other liabilities                                    | 665      |
| Deferred revenue                                     | (306)    |
|                                                      | -----    |
| Cash used in operating activities                    | (7,508)  |
|                                                      | -----    |
| Cash flows from investing activities:                |          |
| Purchases of short-term investments                  | (13,951) |
| Maturities of short-term investments                 | 6,836    |
| Capital expenditures                                 | (207)    |
| Restricted long-term investments                     | --       |
|                                                      | -----    |
| Cash (used in) provided by investing activities      | (7,322)  |
|                                                      | -----    |
| Cash flows from financing activities:                |          |
| Payments on notes payable                            | --       |
| Payments on capital lease obligation                 | (132)    |
| Proceeds from exercise of stock options and warrants | 312      |
|                                                      | -----    |
| Cash provided by financing activities                | 180      |
|                                                      | -----    |
| Effect of exchange rate on cash and cash equivalents | 10       |
| Decrease in cash and cash equivalents                | (14,640) |
| Cash and cash equivalents, beginning of period       | 19,456   |
|                                                      | -----    |
| Cash and cash equivalents, end of period             | \$ 4,816 |
|                                                      | =====    |

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

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EXTENSITY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) which, in the opinion of management, are necessary for a fair presentation of the financial results for the periods shown. The balance sheet as of December 31, 2001 was derived from audited financial statements, but does not include all necessary disclosures required by generally accepted accounting principles.

These condensed consolidated financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company's report on Form 10-K (File No. 000-28897), filed with the Securities and Exchange Commission (the "SEC") on April 1, 2002.

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The condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Extensity Europe Limited, which commenced operations in September 1999. All significant intercompany balances and transactions have been eliminated in consolidation.

The results of operations for the current interim period are not necessarily indicative of the results to be expected for the entire current year or other future interim periods.

### 2. Net Loss Per Share

Basic and diluted net loss per share are computed using the weighted average number of common shares outstanding. Options and warrants were not included in the computation of diluted net loss per share because the effect would be antidilutive.

Diluted net loss per share does not include the effect of the following potential common shares at June 30, 2002 and 2001 (in thousands):

|                                              | June 30, |       |
|----------------------------------------------|----------|-------|
|                                              | 2002     | 2001  |
| Shares issuable under stock options          | 797      | 3,321 |
| Shares of vested stock subject to repurchase | 9        | 300   |
|                                              | 806      | 3,621 |
|                                              | 806      | 3,621 |

### 3. Significant Customers

No customers accounted for more than 10% of total revenues for the three or six-month periods ended June 30, 2002. For the three months ended June 30, 2001, sales to three customers accounted for approximately 21%, 13% and 12% of total revenues. For the six months ended June 30, 2001, sales to one customer accounted for 12% of total revenues.

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### 4. Comprehensive Loss

The components of comprehensive loss are as follows (in thousands):

|                                         | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |             |
|-----------------------------------------|--------------------------------|------------|------------------------------|-------------|
|                                         | 2002                           | 2001       | 2002                         | 2001        |
| Net loss                                | \$ (4,987)                     | \$ (6,733) | \$ (10,082)                  | \$ (14,232) |
| Foreign currency translation adjustment | 5                              | 3          | 37                           | 3           |
| Total comprehensive                     | \$ (4,982)                     | \$ (6,730) | \$ (10,045)                  | \$ (14,229) |
|                                         | \$ (4,982)                     | \$ (6,730) | \$ (10,045)                  | \$ (14,229) |

### 5. Restructuring

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In response to the continuing economic slowdown, the Company implemented a restructuring plan in the third quarter of fiscal 2001 and recorded a restructuring charge of \$4.5 million. The goal of the restructuring plan is to reduce costs and improve operating efficiencies in order to match the current business environment. The restructuring charge consisted of severance and benefits of \$729,000 related to the involuntary termination of 70 employees, which was fully paid as of December 31, 2001. These terminations were from all functions across the Company. In addition, the Company accrued for lease costs of \$2.2 million pertaining to the estimated obligations for non-cancelable lease payments for excess facilities in the United States and Europe. The Company also wrote off computer equipment and software with a net book value of \$1.6 million as these assets were taken out of service because they were deemed unnecessary due to the reductions in workforce.

In April of 2002, the Company took additional steps to reduce expenses, which included reducing full-time equivalent employees at the Company by approximately 18% and evaluating the adequacy of its sublease loss accrual for its lease commitments for office space. The Company incurred a restructuring charge of approximately \$1.5 million for the three months ended June 30, 2002. The charge consisted of severance and benefits of \$523,000 related to the involuntary termination of 39 employees, which was fully paid as of June 30, 2002. In addition, the Company accrued for lease costs of \$946,000 pertaining to the estimated obligations for non-cancelable lease payments for excess facilities in the United States.

The sublease loss accrual as of December 31, 2001 was \$1,286,000. The Company made payments of \$243,000 against the accrual in the six-month period ending June 30, 2002. The sublease loss accrual balance as of June 30, 2002 is \$1,989,000. The Company expects to pay the remaining obligations relating to the non-cancelable lease obligations over the remaining lease terms through 2006.

### 6. Commitments and Contingencies

In November 2001, the Company and certain of its officers and directors were named as defendants in a class action shareholder complaint filed in the United States District Court for the Southern District of New York and now captioned as *In re Extensity, Inc. Initial Public Offering Securities Litigation*. The plaintiffs seek unspecified monetary damages and other relief. The Company believes these charges to be without merit and therefore, has not accrued any amounts in connection with this matter.

We are also subject to various other claims and legal actions arising in the ordinary course of business. The ultimate disposition of these various other claims and legal actions is not expected to have a material effect on our business, financial condition or results of operations.

### 7. Recent Accounting Pronouncements

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

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from goodwill. SFAS No. 142 requires the use of a non-amortization approach to account for purchased goodwill and certain intangibles. Under a non-amortization approach, goodwill and certain intangibles will not be amortized into results of operations, but instead would be reviewed for impairment and written down and charged to results of operations only in the periods in which the recorded value of goodwill and certain intangibles is more than its fair value. The provisions of each statement, which apply to goodwill and intangible assets acquired prior to June 30, 2001, were adopted by the Company on January 1, 2002. The adoption of these accounting standards had no impact on our financial position or results of operations for any historic transactions.

In July 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities". SFAS No. 146 nullifies the guidance of the Emerging Issues Task Force (EITF) in EITF Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)". Under EITF Issue No. 94-3, an entity recognized a liability for an exit cost on the date that the entity committed itself to an exit plan. In SFAS 146, the FASB acknowledges that an entity's commitment to a plan does not, by itself, create a present obligation to other parties that meets the definition of a liability and requires that a liability for a cost that is associated with an exit or disposal activity be recognized when the liability is incurred. It also establishes that fair value is the objective for the initial measurement of the liability. SFAS 146 will be effective for exit or disposal activities that are initiated after December 31, 2002. The Company does not expect an impact on its financial position and results of operating from the adoption of SFAS 146.

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### ITEM 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding the Company's expectations, beliefs, intentions or future strategies that are signified by the words "expects," "anticipates," "intends," "believes," or similar language. All forward-looking statements included in this document are based on information available to the Company on the date hereof, and the Company assumes no obligation to update any such forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. In evaluating the Company's business, prospective investors should carefully consider the information set forth below under the caption "Risk Factors" in addition to the other information set forth herein. The Company cautions investors that its business and financial performance are subject to substantial risks and uncertainties.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our Summary of Condensed Consolidated Financial Data, our condensed consolidated financial statements and related notes included in this report, and Management's Discussion and Analysis of Financial Condition and Results of Operations and related financial information contained in the Company's Form 10-K (File No. 000-28897).

#### Overview

Extensity was formed in November 1995 and introduced its first commercial product for general availability in March 1998. During this period, our operating activities consisted of the design and development of our product



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architecture and our first application, the building of our corporate infrastructure, and the development of our professional services and customer support organizations. Our first application, Extensity Expense Reports, was released for general availability in March 1998. We released Extensity Travel Plans in December 1998 and Extensity Timesheets and Extensity Purchase Reqs in July 1999. Extensity Connect, our portalized application front end, role-based reporting tool, and content and commerce gateway was released in March 2000. We introduced the newest version of our suite of products, Extensity 6, in June 2002.

We generate revenue principally from licensing our applications and providing related services, including product installation, maintenance and support, consulting and training. We license our applications individually or as an integrated suite of products. The pricing of our software and services fluctuates on a per transaction basis depending on various factors, such as the number of seats covered by a contract and the degree of customization requested by the particular customer. The dollar amounts of our contracts depend on the number of users and applications being used and the professional services requested. In the third quarter of 2001, we began recognizing revenue from our hosted offering. Under this offering, customers pay a monthly usage fee based on the number of users and a one-time set-up fee to access the Extensity application on our servers.

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We promote and sell our software products through our direct sales force and through indirect channels, including Elite Information Group and Emplaza, S.A., a joint venture between Terra Networks and Meta4. We also have marketing referral arrangements in place with Cisco Systems, IBM, US Bank, Amadeus/eTravel, Rosenbluth Travel, WebEx, DigitalThink, Visa, GetThere.com, and ProAct Technologies.

For the six months ended June 30, 2002 and 2001, revenues derived from our international operations represented approximately 12% of total revenues.

### Critical Accounting Policies

A summary of the Company's critical accounting policies is included in our report on Form 10K for the year ended December 31, 2001.

### Results of Operations

The following table sets forth certain statement of operations data in absolute dollars for the periods indicated. The data has been derived from the condensed consolidated financial statements contained in this report. The operating results discussed below do not include the amortization of non-cash stock based compensation. These amounts are discussed separately within this discussion.

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### Summary Condensed Consolidated Financial Data (In thousands) (Unaudited)

Three Months Ended  
June 30,

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|                                                                                       | 2002     | 2001     |      |
|---------------------------------------------------------------------------------------|----------|----------|------|
| Revenues:                                                                             |          |          |      |
| License                                                                               | \$ 1,743 | \$ 5,651 | \$ 2 |
| Service and maintenance                                                               | 3,074    | 3,480    | 6    |
| Hosted                                                                                | 194      | --       |      |
| Total revenues                                                                        | \$ 5,011 | \$ 9,131 | \$ 9 |
| Cost of revenues: (*)                                                                 |          |          |      |
| License                                                                               | \$ 144   | \$ 263   | \$   |
| Service and maintenance                                                               | 1,843    | 3,435    | 4    |
| Hosted                                                                                | 340      | --       |      |
| Total cost of revenues                                                                | \$ 2,327 | \$ 3,698 | \$ 5 |
| Operating expenses: (*)                                                               |          |          |      |
| Sales and marketing                                                                   | \$ 2,894 | \$ 7,025 | \$ 6 |
| Research and development                                                              | 1,830    | 3,934    | 3    |
| General and administrative                                                            | 1,472    | 1,839    | 2    |
| Restructuring and other non recurring charges                                         | 1,695    | --       | 1    |
| Interest income, net                                                                  | \$ 220   | \$ 687   | \$   |
| (*) Amounts exclude the amortization of non-cash stock based compensation as follows: |          |          |      |
| Cost of revenues:                                                                     |          |          |      |
| Service and maintenance                                                               | \$ --    | \$ 9     | \$   |
| Operating expenses:                                                                   |          |          |      |
| Sales and marketing                                                                   | --       | 18       |      |
| Research and development                                                              | --       | 11       |      |
| General and administrative                                                            | --       | 17       |      |
|                                                                                       | \$ --    | \$ 55    | \$   |

Revenues

Total revenues decreased to \$5.0 million for the three months ended June 30, 2002 from \$9.1 million for the three months ended June 30, 2001, a decrease of 45%. Total revenues decreased to \$9.5 million for the six months ended June 30, 2002 from \$18.9 million for the six months ended June 30, 2001, a decrease of 50%. No customers accounted for more than 10% of total revenues for the three or six-month periods ended June 30, 2002. Sales to three customers accounted for approximately 21%, 13% and 12% of total revenues for the three months ended June 30, 2001 and sales to one customer accounted for approximately 12% of total revenues for the six months ended June 30, 2001.

License Revenues. Our license revenues decreased to \$1.7 million for the three months ended June 30, 2002 from \$5.7 million for the three months ended June 30, 2001, a decrease of 69%. License revenue decreased to \$2.9 million for the six months ended June 30, 2002 from \$11.7 million for the six

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months ended June 30, 2001, a decrease of 75%. The decrease in license revenue for the three and six-month periods ended June 30, 2002 was attributable to a decrease in revenue recognized on shipment from our direct and indirect sales channels which have been impacted by the decrease in capital spending associated with the current global economic downturn. In the three months ended June 30, 2001, \$1.9 million of license revenue was recognized through the Company's relationship with a reseller. The Company and the reseller jointly decided to terminate the reseller arrangement.

**Service and Maintenance Revenues.** Our service and maintenance revenues decreased to \$3.1 million for the three months ended June 30, 2002 from \$3.5 million for the three months ended June 30, 2001, a decrease of 12%. Service and maintenance revenues decreased to \$6.2 million for the six months ended June 30, 2002 from \$7.3 million for the six-month period ended June 30, 2001, a decrease of 15%. The decrease in the three and six-month periods ended June 30, 2002 was attributable to a decrease in professional services billing opportunities resulting from a decrease in capital spending associated with current global economic conditions.

**Hosted Revenues.** Our hosted revenues were \$194,000 and \$388,000 for the three and six-month periods ended June 30, 2002, respectively. This is the fourth quarterly period the Company has recognized revenue from this offering. The Company does not believe these revenues will be a significant percentage of total revenues in the near term.

### Cost of Revenues

Total cost of revenues decreased to \$2.3 million for the three months ended June 30, 2002 from \$3.7 million for the three months ended June 30, 2001, a decrease of 37%. Total cost of revenues decreased to \$5.1 million for the six months ended June 30, 2002 from \$8.2 million for the six months ended June 30, 2001, a decrease of 38%.

**Cost of License Revenues.** Cost of license revenues consists primarily of third-party license and support fees and, to a lesser extent, costs of duplicating media and documentation and shipping. Cost of license revenue decreased to \$144,000 for the three months ended June 30, 2002 from \$263,000 for the three months ended June 30, 2001. Cost of license revenue decreased to \$249,000 for the six months ended June 30, 2002 from \$708,000 for the six months ended June 30, 2001. The decrease in cost for both the three and six-month periods ended June 30, 2002 was due primarily to decreased sales activity. As a percentage of license revenues, cost of license revenues increased to 8% for the three months ended June 30, 2002 from 5% for the three months ended June 30, 2001. As a percentage of license revenues, cost of license revenues increased to 8% for the six months ended June 30, 2002 from 6% for the six months ended June 30, 2001. Cost of revenues as a percentage of license revenue may increase over the current level in the future if we incorporate additional third-party products into our offerings.

**Cost of Service and Maintenance Revenues.** Cost of service and maintenance revenues consists of compensation and related overhead costs for personnel engaged in consulting, training, maintenance and support services for our customers as well as costs for third parties contracted to provide such services to our customers. The cost of service and maintenance revenue decreased to \$1.8 million for the three months ended June 30, 2002 from \$3.4 million for the three months ended June 30, 2001, a decrease of 46%. The cost of service and maintenance revenues decreased to \$4.2 million for the six months ended June 30, 2002 from \$7.5 million for the six months ended June 30, 2001, a decrease of 43%. As a percentage of service revenues,

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cost of service revenues decreased to 60% for the three months ended June 30, 2002 from 99% for the three months ended June 30, 2001. As a percentage of service revenues, cost of service revenues decreased to 68% for the six months ended June 30, 2002 from 103% for the six months ended June 30, 2001. The decrease for the three and six-month periods ended June 30, 2002 was attributable to lower compensation costs associated with our restructuring plans implemented in July of 2001 and April 2002 and lower costs for third party consultants. The Company does not expect these costs to significantly increase in the near term. Overall, we are seeking to further reduce our cost of service revenues as a percentage of total service revenue and are also seeking to keep third parties engaged in providing services related to our applications.

**Cost of Hosted Revenues.** Cost of hosted revenues consists primarily of compensation and related overhead costs for personnel engaged in supporting the hosted customer base, server costs, and telecommunications charges. For the three months ended June 30, 2002, cost of hosted revenues was \$340,000. For the six months ended June 30, 2002, cost of hosted revenues was \$606,000. The Company does not expect these costs to significantly increase in the near term.

### Operating Expenses

**Sales and Marketing.** Sales and marketing expenses consist primarily of compensation and related costs for sales and marketing personnel, including commissions and marketing program costs. Sales and marketing expenses decreased to \$2.9 million for the three months ended June 30, 2002 from \$7.0 million for the three months ended June 30, 2001, a decrease of 59%. Sales and marketing expenses decreased to \$6.4 million for the six months ended June 30, 2002 from \$14.8 million for the six months ended June 30, 2001, a decrease of 57%. As a percentage of total revenues, sales and marketing expenses decreased to 58% for the three months ended June 30, 2002 from 77% for the three months ended June 30, 2001. As a percentage of total revenues, sales and marketing expenses decreased to 67% for the six months ended June 30, 2002 from 78% for the six months ended June 30, 2001. The decrease in sales and marketing expenses for the three and six-month periods ended June 30, 2002 was attributed to reduced commission expense associated with the decrease in license revenue and reduced compensation costs and lower program costs associated with our restructuring plans implemented in July 2001 and April 2002. We do not expect sales and marketing expenses, excluding commission charges, to increase significantly in the near term. Commission charges will vary depending upon the sales activity. Sales and marketing expenses may increase in the long term if we expand our domestic and international sales force and increase our marketing efforts.

**Research and Development.** Research and development expenses consist primarily of compensation and related personnel costs, and fees associated with contractors. Research and development expenses decreased to \$1.8 million for the three months ended June 30, 2002 from \$3.9 million for the three months ended June 30, 2001, a decrease of 53%. Research and development expenses decreased to \$3.9 million for the six months ended June 30, 2002 from \$7.7 million for the six months ended June 30, 2001, a decrease of 49%. As a percentage of total revenues, research and development expenses decreased to 37% for the three months ended June 30, 2002 from 43% for the three months ended June 30, 2001. As a percentage of total revenues, research and development expenses were 41% for both six-month periods ended June 30, 2002 and June 30, 2001. The decrease in research and development cost for the three and six-month periods ended June 30, 2002 was attributable to reduced compensation costs associated with our restructuring plans implemented in July of 2001 and April 2002. We do not expect research and development costs to significantly increase in the near term. Research and development expenses may increase in the long term if we make additional investments in our technology and products.

General and Administrative. General and administrative expenses consist primarily of compensation and related costs for our executive, finance and administrative personnel and other related expenses. General and administrative expenses decreased to \$1.5 million for the three months ended June 30, 2002 from \$1.8 million for the three months ended June 30, 2001, a decrease of 20%. General and administrative expenses decreased to \$3.0 million for the six months ended June 30, 2002 from \$3.5 million for the six months ended June 30, 2001, a decrease of 16%. As a percentage of total revenues, general and administrative expenses increased to 29% for the three months ended June 30, 2002 from 20% for the three months ended June 30, 2001. As a percentage of total revenues general and administrative expenses increased to 31% for the six months ended June 30, 2002 from 19% for the six months ended June 30, 2001. The decrease in general and administrative expenses in the three and six-month periods ended June 30, 2002 was primarily attributable to the impact of our restructuring plans implemented in July of 2001 and April 2002. General and administrative expenses tend to be relatively fixed in the short term because the Company's discretionary general and administrative expenses are limited and there are significant costs associated with being a public company. As a result, declining revenues have caused an increase in general and administrative expenses as a percentage of total revenues. We do not expect general and administrative expenses to significantly increase in the short term. General and administrative costs may increase in the long term if we expand our operations.

Restructuring and other non-recurring charges. For the three and six months ended June 30, 2002, restructuring and other non-recurring charges were approximately \$1.7 million, comprised of \$523,000 of severance and benefits associated with the termination of 39 employees, \$946,000 of accrued lease costs pertaining to the estimated obligations for non-cancelable lease payments for excess facilities in the United States and \$225,000 of other non-recurring general and administrative charges incurred in connection with exploring merger and acquisition transactions. The entire other non-recurring general and administration charge was expensed in the three months ended June 30, 2002. There were no other non-recurring charges for the three months ended June 30, 2001 and there were \$377,000 of other non-recurring charges incurred in the six months ended June 30, 2001. These charges were incurred in connection with exploring potential merger and acquisition transactions. The entire charge was expensed in the three months ended March 31, 2001 as these discussions were terminated.

#### Interest Income, Net

Interest income, net was \$220,000 for the three months ended June 30, 2002 and \$687,000 for the three months ended June 30, 2001, a decrease of 68%. Interest income, net was \$490,000 for the six months ended June 30, 2002 and \$1.8 million for the six months ended June 30, 2001, a decrease of 72%. Interest income is attributed to interest earned on the proceeds from the Company's initial public offering ("IPO") and working capital. The decrease in interest income for both the three and six-month periods ended June 30, 2002 is attributed to lower interest rates and lower cash, cash equivalent and short-term investments balances. Interest income will fluctuate depending upon the overall interest rate environment and our cash, cash equivalent and short-term investments balances.

#### Amortization of Non-Cash Stock Based Compensation

Prior to our IPO, we granted certain stock options to our officers and employees at prices deemed to be below the fair value of the underlying stock. The cumulative difference between the fair value of the underlying stock at the

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date the options were granted and the exercise price of the granted options was \$12.1 million as of the IPO date. This amount is being amortized using the accelerated method of FASB Interpretation No. 28, "Accounting for Stock

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Appreciation Rights and Other Variable or Award Plans", over the four-year vesting period of the granted options. Accordingly, our results of operations include and will continue to include deferred compensation expense at least through 2003. No expense was recognized in the three months ended June 30, 2002. For the three months ended June 30, 2001, amortization of non-cash based compensation was \$55,000. For the six months ended June 30, 2002, amortization of non-cash based compensation was \$21,000 and for the six months ended June 30, 2001, amortization of non-cash based compensation was \$348,000. The lower expense in both the three and six-month periods in 2002 is primarily attributable to the impact of forfeitures and the use of an accelerated method of amortization. We estimate that we will recognize approximately \$68,000 for the remainder of 2002; however, this amount may change as employee terminations impact the amortization schedule.

### Liquidity and Capital Resources

Since inception, we have financed our operations and funded our capital expenditures through proceeds from our IPO completed in January 2000 and the private sale of equity securities, supplemented by loan facilities and equipment leases. As of June 30, 2002, we had \$38.8 million in cash, cash equivalents and short-term investments, \$1.4 million in restricted long-term investments and \$33.6 million in working capital.

Net cash used in operating activities was \$7.5 million for the six months ended June 30, 2002 and \$18.2 million for the six months ended June 30, 2001. For the six months ended June 30, 2002 cash used in operating activities was primarily attributed to a net loss of \$10.1 million, adjusted for a depreciation and amortization of \$850,000, and a decrease in accounts receivable of \$1.7 million. For the six months ended June 30, 2001 net cash used in operating activities was primarily attributable to a net loss of \$14.2 million, adjusted for depreciation and amortization of \$1.4 million and amortization of deferred stock compensation and other of \$433,000, a decrease in deferred revenue of \$7.1 million, and a decrease in accrued liabilities of \$1.2 million offset by a decrease in accounts receivable of \$3.0 million.

Net cash used in investing activities was \$7.3 million for the six months ended June 30, 2002 and net cash provided by investing activities was \$15.3 million for the six months ended June 30, 2001. Net cash used in investing activities for the six months ended June 30, 2002 was primarily attributable to the purchases of short-term investments. Net cash provided by investing activities for the six months ended June 30, 2001 was primarily attributable to maturities of short-term investments.

Net cash provided by financing activities was \$180,000 for the six months ended June 30, 2002 due to payments on capital lease obligations of \$132,000 offset by proceeds from employee stock plans of \$312,000. Net cash provided by financing activities was \$105,000 for the six months ended June 30, 2001, primarily due to payments on notes payable and capital lease obligations of \$839,000, offset by proceeds from employee stock plans of \$944,000.

Presently, we anticipate that our existing capital resources will meet our operating and investing needs for at least the next twelve months. In particular, we believe that our current cash balances are sufficient to fund any existing cash obligations or commercial commitments as well as any cash needed

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for planned operating activities. Furthermore, should our operating results be worse than expected, we could use more cash in funding operating activities which would diminish our capital resources. While we do not presently anticipate a need for additional capital, if we do require additional capital resources to grow our business, execute our operating plans, or acquire complementary technologies or businesses, at any time in the future, we may seek to sell additional equity or debt securities or secure additional lines of credit, which may result in additional dilution to our stockholders. Additional funding may or may not be available on acceptable terms or at all.

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### RISK FACTORS

The following is a discussion of certain factors that currently impact or may impact our business, operating results and/or financial condition. Any investment in our common stock involves a high degree of risk. You should consider carefully the following information about these risks in evaluating our business. The market price of our common stock could decline, and you may lose all or part of the money you paid to buy our common stock.

#### RISKS RELATED TO OUR BUSINESS

Our limited operating history and the fact that we operate in a new industry make our business prospects difficult to evaluate.

We were incorporated in November 1995 and commenced licensing of our software applications in March 1998. An investor in our common stock must consider the risks, uncertainties, expenses and difficulties frequently encountered by companies in their early stages of development, particularly companies in new and rapidly evolving markets such as the market for employee relationship management software applications. Risks and difficulties include our ability to:

- expand our base of customers with fully installed and deployed systems that can serve as reference accounts for our ongoing sales efforts;
- expand our pipeline of sales prospects in order to promote greater predictability in our period-to-period sales levels;
- continue to offer new products that complement our existing product line, in order to make our suite of applications more attractive to customers;
- continue to develop and upgrade our technology to add additional features and functionality;
- continue to attract and retain qualified personnel;
- expand direct sales channels and indirect channels such as relationships with OEM customers and distributors;
- increase awareness of our brand; and
- maintain our current and develop new third-party relationships, including but not limited to third-party implementers.

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The Company may not be able to successfully address these risks or difficulties and our business strategy may not be successful. If we fail to address these risks or difficulties adequately, our business will likely suffer.

We have a history of losses and negative cash flow and expect this to continue into the current fiscal year.

Our business is new; we have offered products for a relatively short period of time; and our base of customers and prospective customers is still relatively small. We have spent significant funds to date to develop our current products and to develop our sales and market resources.

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We have incurred significant operating losses and have not achieved profitability. As of June 30, 2002, we had an accumulated deficit of \$110.5 million. We expect to continue to invest in research and development to enhance current products and develop future products and support our current sales and marketing efforts that promote our company and our products in the marketplace. As a result, we will need to increase our revenues significantly to achieve profitability. In addition, because we expect to continue to invest in our business ahead of anticipated future revenues, we expect that we will continue to incur operating losses through the current fiscal year.

Our business is changing rapidly, which could cause our quarterly operating results to vary and our stock price to fluctuate.

Our revenues and operating results may vary significantly from quarter to quarter due to a number of factors, many of which are beyond our control. Even after our reorganization in April of 2002, where headcount was significantly reduced, we expect to continue to make expenditures in all areas of our business in order to promote future revenue growth. Because the expenses associated with these activities are relatively fixed in the short-term, we will be unable to adjust spending quickly enough in any particular quarter to offset any unexpected shortfall in revenue. As a result, we expect our quarterly operating results to fluctuate. Our financial results may, as a consequence of quarterly revenue fluctuations, fall short of the expectations of public market analysts or investors. If this occurs, the price of our common stock may drop.

We also seek to develop and maintain a significant pipeline of potential sales prospects, but it is difficult to predict when individual customer orders will be closed. Our base of customers and the number of additional customer licenses we enter into each quarter are still relatively small. Accordingly, the loss or deferral of a small number of anticipated large customer orders in any quarter could result in a significant shortfall in revenues for that quarter and future quarters, which could result in a drop in the price of our stock.

Other important factors that could cause our quarterly results and stock price to fluctuate materially include:

- our ability to grow our customer base and our base of referencing customers, in light of our relatively limited number of customers to date;
- our ability to successfully develop alternative sales channels for our products, such as sales through OEM customers or distributors;
- our ability to expand our implementation and consulting



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resources through third-party relationships, in light of the fact that we have limited third-party implementation and consulting relationships currently in place;

- technical difficulties or "bugs" affecting the operation of our software; and
- delays in the introduction of new or enhanced versions of our products.

Due to our limited operating history, the early stage of our market and the factors discussed above, you should not rely on quarter-to-quarter comparisons of our results of operations as indicators of our future performance.

We face intense competition, which could affect our ability to increase revenue, maintain our margins and increase market share.

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The market for our internet-based employee relationship management software applications is intensely competitive and we expect competition to increase in the future. Competitors vary in size and in the scope and breadth of the products and services they offer. Companies offering one or more products directly competitive with our products include Ariba, Concur Technologies, IBM, PeopleSoft and Oracle. As a result of the large market opportunity for employee relationship management solutions we also expect competition from other established and emerging companies.

Many of our current and potential competitors have longer operating histories, significantly greater financial, technical, marketing and other resources, significantly greater name recognition, and a larger installed base of customers than us. In addition, many of our competitors have well-established relationships with our current and potential customers and have extensive knowledge of our industry. Current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address customer needs. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. We also expect that competition will increase as a result of industry consolidation. Increased competition may result in price reductions, reduced margins and loss of market share, any one of which could seriously harm our business.

If we do not provide software applications and related services that meet the changing demands of our customers, the market for our products will not grow or may decline, and our product sales will suffer.

To successfully implement our business strategy, we have to provide software applications and related services that meet the demands of our customers and prospective customers as the market and customer requirements evolve. We expect that competitive factors will create a continuing need for us to improve and add to our suite of software applications. Not only will we have to expend additional funds and other resources to continue to improve our existing suite of applications, but we must also properly anticipate, address and respond to customer preferences and demands. As organizations' needs change with respect to their enterprise applications, our existing suite of software applications may become obsolete or inefficient relative to our competitors' offerings and may require modifications or improvements. The addition of new products and services will also require that we continue to improve the technology underlying our applications. These requirements could be significant,

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and we may fail to fulfill them quickly and efficiently. If we fail to expand the breadth of our applications quickly in response to customer needs or if these offerings fail to achieve market acceptance, the market for our products will not grow or may decline, and our business may suffer significantly.

Our employee relationship management software products and related services have accounted for substantially all of our revenues to date. We anticipate that revenues from these products and related services will continue to constitute substantially all of our revenues for the foreseeable future. Consequently, our future financial performance will depend, in significant part, upon the successful development, introduction and customer acceptance of enhanced versions of our employee relationship management software applications and any new products or services that we may develop or acquire. We cannot assure you that we will be successful in enhancing, upgrading or continuing to effectively market our employee relationship management software applications or that any new products or services that we may develop or acquire will achieve market acceptance.

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In any given quarter, our revenues have been derived from a relatively small number of customers, and the loss of a small number of major customers or potential customers could adversely impact our quarterly revenues or operating results.

We expect that we will continue to derive a significant portion of our revenues from a relatively small number of customers in the future. Accordingly, the loss of a small number of major customers could materially and adversely affect our business, and the deferral or loss of anticipated orders from a small number of prospective customers could materially and adversely impact our quarterly revenues and operating results in any period.

If we are unable to maintain our Nasdaq National Market listing, the liquidity of our common stock would be seriously limited.

Since July 3, 2002, our stock had minimum closing bid prices of less than \$1.00 per share, which is the minimum bid price requirement for continued listing with the Nasdaq National Market. If we fail to comply with the minimum bid price requirement for 30 straight trading days, we will likely receive a deficiency notice from the Nasdaq National Market. We will then have 90 calendar days to reestablish compliance with that requirement. To reestablish compliance, our minimum closing bid price must be more than \$1.00 per share for 10 consecutive trading days. If we do not reestablish compliance with this requirement during the 90-day period, Nasdaq will commence delisting proceedings and we may be delisted from the Nasdaq National Market. Our shares will continue to trade on the Nasdaq National Market unless and until the delisting proceedings have commenced and been completed and the Nasdaq National Market has made a determination to delist us. In the event our shares are delisted from the Nasdaq National Market, we will attempt to have our common stock traded on the Nasdaq Small Cap Market. If our common stock is delisted, it could seriously limit the liquidity of our common stock and would limit our ability to raise future capital through the sale of our common stock, which could seriously harm our business.

If we fail to maintain positive margins on service revenues in the foreseeable future, our results of operations could suffer.

For the three-month and six-month periods ended June 30, 2002, our service margins were positive. While we anticipate that our margins will continue to be positive in the future, we cannot guarantee that they will remain

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positive. Failure to maintain positive margins on service revenues would cause our business to suffer. For more information related to our costs associated with our service revenues, see "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Evolving technological developments and emerging industry standards will require us to enhance the functionality of our employee relationship management software applications, and any inability to enhance functionality could cause our sales to decline.

Because the market for our products is subject to rapid technological change and evolving industry standards, the life cycles of our products are difficult to predict. Competitors may introduce new products or enhancements to existing products employing new technologies, which could render our existing products and services obsolete and unmarketable. For example, our currently available software applications are written entirely in the Java computer language. While we believe that this provides our solution with significant advantages in terms of functionality and flexibility, it is not clear whether Java-based systems will continue to maintain commercial acceptance.

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To be successful, our products and services must keep pace with technological developments and emerging industry standards, address the ever-changing and increasingly sophisticated needs of our customers and achieve market acceptance. Our results of operations would be seriously harmed if we are unable to develop, release and market new software product enhancements on a timely and cost-effective basis, or if new products or enhancements do not achieve market acceptance or fail to respond to evolving industry or technology standards.

In developing new products and services, we may also fail to develop and market products that respond to technological changes or evolving industry standards in a timely or cost-effective manner, or experience difficulties that could delay or prevent the successful development, introduction and marketing of these new products and services.

If we fail to expand our relationships with third parties that can provide implementation and consulting services to our customers, we may be unable to grow our revenues and our business could be harmed.

In order for us to focus more effectively on our core business of developing and licensing software solutions, we must continue to establish relationships with third parties that can provide implementation and consulting services to our customers. Third-party implementation and consulting firms can also be influential in the choice of employee relationship management software applications by new customers. To date, we have established relationships with several third-party implementation and consulting firms. In general, however, if we are unable to establish and maintain effective, long-term relationships with implementation and consulting providers, or if these providers do not meet the needs or expectations of our customers, we may be unable to grow our revenues and our business could be seriously harmed. As a result of the limited resources and capacities of many third-party implementation providers, we may be unable to attain sufficient focus and resources from the third-party providers to meet all of our customers' needs, even if we establish relationships with these third parties. If sufficient resources are unavailable, we will be required to provide these services internally, which could limit our ability to expand our base of customers. A number of our competitors have significantly more established relationships with these third parties and, as a result, these third parties may be more likely to recommend competitors' products and services rather than our

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own. Even if we are successful in developing additional relationships with third-party implementation and consulting providers, we will be subject to significant risk, as we cannot control the level and quality of service provided by third-party implementation and consulting partners.

Our expectations of future growth depend on our ability to expand internationally, and factors specific to our international expansion may prevent us from achieving our anticipated growth.

Over time, we intend to expand our international operations to achieve our anticipated growth, but we may face significant challenges to our international expansion. The expansion of our existing international operations and entry into additional international markets will require significant management attention and financial resources. To achieve broad acceptance in international markets, our products must be localized to handle a variety of factors specific to each international market, such as tax laws and local regulations. The incorporation of these factors into our products is a complex process and often requires assistance from third parties. We may not adequately address all of the factors necessary to achieve broad acceptance in our target international markets. Further, to achieve broad usage by employees across international organizations, our products must be localized to handle native languages and cultures in each international market. Localizing our products is also a complex process and we intend to continue working with third parties to develop localized products. To date, we have

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localized our product for the markets where the English language is the native language and completed translations for the German, French, Italian and Spanish languages.

We have only a limited history of marketing, selling and supporting our products and services internationally. In 1999, we opened a regional office in the United Kingdom. In 2000, we expanded our European Operations through opening a second office in Frankfurt, Germany; however, as part of our restructuring plan implemented in April of 2002, we closed the Frankfurt office. As of June 30, 2002, we had a total of 10 employees in our international operations. For the six months ended June 30, 2002, we derived approximately 12% of our revenues from our international operations. To succeed internationally, we must react quickly to the business environment in which we operate overseas. Thus, we must effectively monitor the size of our international workforce and make adjustments as necessary. During periods of growth we must hire and train experienced international personnel as well as recruit and retain qualified domestic personnel to staff and manage our international operations. However, we may experience difficulties in recruiting and training additional international staff. We must also be able to enter into strategic relationships with companies in international markets. If we are not able to maintain successful strategic relationships internationally or recruit additional companies to enter into strategic relationships, our future growth could be limited. We also face other risks inherent in conducting business internationally, such as:

- difficulties in collecting accounts receivable and longer collection periods;
- seasonal business activity in certain parts of the world;
- fluctuations in currency exchange rates; and
- trade barriers.

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Any of these factors could seriously harm our international operations and, consequently, our business.

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Our sales cycles are long and unpredictable, which makes period-to-period revenues difficult to predict.

Because the market for our employee relationship management software products and related services is relatively new, we experience long and unpredictable sales cycles. The sales cycle for our employee relationship management software applications typically ranges from two to nine months. Our customers have frequently viewed the purchase of our products as part of a long-term strategic decision regarding the management of their workforce-related operations and expenditures. This decision process has sometimes resulted in customers taking a long period of time to assess alternative solutions by our competitors or deferring a purchase decision until the market evolves. Sales cycles continue to be long and the timing of purchase decisions by individual customers remain at times uncertain. We must continue to educate potential customers on the use and benefits of our products and services, as well as the integration of our products and services with additional software applications utilized by the individual customers. Because the sales cycle is long and timing of individual orders is uncertain, our period-to-period revenues are difficult to predict.

We may be unable to attract and retain highly skilled employees that are necessary for the success of our business plan.

Our ability to execute our business plan and be successful also depends on our continued ability to attract and retain highly skilled employees. We depend on the services of senior management and other personnel, particularly Robert A. Spinner, our Chief Executive Officer. None of our senior management is obligated to continue to provide services to the Company. Over time, we will need to hire additional personnel in all operational areas. Competition for personnel in our industry is intense. We have in the past experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled employees with appropriate qualifications. If we do not succeed in attracting or retaining personnel, our business could be adversely affected.

Software defects could lead to loss of revenue or delay the market acceptance of our applications.

Our enterprise applications software is complex and, accordingly, may contain undetected errors or failures when first introduced or as new versions are released. This may result in loss of, or delay in, market acceptance of our products. We have in the past discovered software errors in our new releases and new products after their introduction. In the event that we experience significant software errors in future releases, we could experience delays in the release, customer dissatisfaction and lower revenues and service margins during the period required to correct these errors. We may in the future discover errors, and additional scalability limitations, in new releases or new products after the commencement of commercial shipments. Any of these errors or defects could cause our business to be materially harmed.

We may become increasingly dependent on third-party software incorporated in our products and, if so, impaired relations with these third parties, errors in third-party software or inability to enhance the software over time could harm our business.

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We incorporate third-party software into our products. Currently, the third-party software we use includes application server software that we license from BEA Systems, off-line database software from Pointbase, off-line client server software from Pumatech, synchronization software from Aether Systems, reporting software from Business Objects and Java Web Start from Sun Microsystems. We may incorporate additional third-party software into our products as we

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expand our product line and broaden the content and services accessible through our gateway. The operation of our products would be impaired if errors occur in the third-party software that we license. It may be more difficult for us to correct any errors in third-party software because the software is not within our control. Accordingly, our business would be adversely affected in the event of any errors in this software. Furthermore, it may be difficult for us to replace any third-party software if a vendor seeks to terminate our license to the software.

Our success depends in part upon our ability to protect our intellectual property and we may not be able to do so adequately.

Our success depends in large part upon our proprietary technology. We rely on a combination of copyright, trademark and trade secret protection, confidentiality and nondisclosure agreements and licensing arrangements to establish and protect our intellectual property rights. We license rather than sell our solutions and require our customers to enter into license agreements, which impose restrictions on their ability to utilize the software. In addition, we seek to avoid disclosure of our trade secrets through a number of means, including requiring those persons with access to our proprietary information to execute nondisclosure agreements with us and restricting access to our source code. We seek to protect our software, documentation and other written materials under trade secret and copyright laws, which afford only limited protection.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. Policing unauthorized use of our products is difficult, and while we are unable to determine the extent to which piracy of our software products exists, software piracy can be expected to be a persistent problem. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States of America. Our means of protecting our proprietary rights may not be adequate and our competitors may independently develop similar technology, duplicate our products, or design around our proprietary intellectual property.

Security and other concerns may discourage customers from purchasing our hosted product.

If customers determine that our hosted product is not scaleable, does not provide adequate security for the dissemination of information over the Internet, or is otherwise inadequate for Internet-based use, or if for any other reason customers fail to accept our hosted products for use on the Internet or on a subscription basis, our business will be harmed. As a hosted provider, we expect to receive confidential information including credit card, travel booking, employee, purchasing, supplier, and other financial and accounting data, through the Internet and there can be no assurance that this information will not be subject to computer break-ins, theft, and other improper activity that could jeopardize the security of information for which we are responsible. Any such lapse in security could expose us to litigation, loss of customers, or otherwise harm our business. In addition, any person who is able to circumvent

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our security measures could misappropriate proprietary or confidential customer information or cause interruptions in our operations. We may be required to incur significant costs to protect against security breaches or to alleviate problems caused by breaches. Additionally, in the past, computer viruses and software programs that disable or impair computers have been distributed and have rapidly spread over the Internet. Computer viruses could be introduced into our systems or those of our customers or suppliers, which could disrupt our software solutions or make them inaccessible to customers or suppliers. Further, a well-publicized compromise of security could deter people from using the Internet to conduct transactions that involve transmitting confidential information. Our failure to prevent security breaches, or well-publicized security

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breaches affecting the Internet in general, could significantly harm our business, operating results and financial condition.

We may face costly damages or litigation costs if a third party claims that we infringe its intellectual property.

There has been a substantial amount of litigation in the software industry and the Internet industry regarding intellectual property rights. It is possible that in the future, third parties may claim that we or our current or potential future products infringe upon their intellectual property. We expect that software product developers and providers of Internet-based software applications will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Any claims, with or without merit, could be time consuming, result in costly litigation, cause product shipment delays or require us to enter into royalty or licensing agreements. Royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all, which could seriously harm our business.

We are the target of a securities class action complaint and are at risk of securities class action litigation, which may result in substantial costs and divert management attention and resources.

In November 2001, the Company and certain of its officers and directors were named as defendants in a class action shareholder complaint filed in the United States District Court for the Southern District of New York now captioned *In re Extensity, Inc. Initial Public Offering Securities Litigation*. In the complaint, the plaintiffs allege that the Company, certain of its officers and directors and the underwriters of its initial public offering ("IPO") violated the federal securities laws because the Company's IPO registration statement and prospectus contained untrue statements of material fact or omitted material facts regarding the compensation to be received by, and the stock allocation practices of, the IPO underwriters. The plaintiffs seek unspecified monetary damages and other relief. Similar complaints were filed in the same court against hundreds of public companies that conducted IPOs of their common stock since the mid-1990s. This action may divert the efforts and attention of management and, if determined adversely to the Company, could have a material impact on our business.

Any future acquisitions of companies or technologies may result in distraction of our management and disruptions to our business.

We may acquire or make investments in complementary businesses, technologies, services or products if appropriate opportunities arise. From time to time we may engage in discussions and negotiations with companies regarding

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our acquiring or investing in such companies' businesses, products, services or technologies. We cannot make assurances that we will be able to identify future suitable acquisition or investment candidates, or if we do identify suitable candidates, that we will be able to make such acquisitions or investments on commercially acceptable terms or at all. If we acquire or invest in another company, we could have difficulty assimilating that company's personnel, operations, technology or products and service offerings. In addition, the key personnel of the acquired company may decide not to work for us. These difficulties could disrupt our ongoing business, distract our management and employees, increase our expenses and adversely affect our results of operations. Furthermore, we may incur indebtedness or issue equity securities to pay for any future acquisitions. The issuance of equity securities could be dilutive to our existing stockholders.

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We have anti-takeover provisions in our charter and in our contracts that could delay or prevent an acquisition of our company, even if such an acquisition would be beneficial to our stockholders.

Provisions of our certificate of incorporation, our bylaws, Delaware law and certain agreements entered into by or for the benefit of some of our key officers could make it more difficult for a third party to acquire us, even if doing so might be beneficial to our stockholders.

Our business may face additional risks and uncertainties not presently known to us, which would cause our business to suffer.

In addition to the risks specifically identified in this Risk Factors section or elsewhere in this Annual Report, we may face additional risks and uncertainties not presently known to us or that we currently deem immaterial which ultimately may impair our business, results of operations and financial condition.

### RISKS RELATED TO OUR INDUSTRY

Our success will depend upon the growth and acceptance of the market we address and our ability to meet the needs of the emerging market for employee relationship management software applications.

The market for our employee relationship management software applications and services is at an early stage of development. Our success will depend upon the continued development of this market and the increasing acceptance by customers of the benefits to be provided by employee relationship management applications and services. In addition, as the market evolves, it is unclear whether the market will accept our suite of applications as a preferred solution for employee relationship management needs. Accordingly, our products and services may not achieve significant market acceptance or realize significant revenue growth. Unless a critical mass of organizations and their suppliers use our solutions and recommend them to new customers, our solutions may not achieve widespread market acceptance, which may cause our business to suffer.

Market prices of technology companies have been highly volatile, and the market for our stock may continue to be volatile as well.

The stock market has experienced significant price and trading volume fluctuations and the market prices of technology companies generally, and Internet-related software companies particularly, have been extremely volatile.



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Investors may not be able to resell their shares at or above the price they paid for the stock. In the past, following periods of volatility in the market price of a public company's securities, securities class action litigation has often been instituted against that company. Such litigation would likely result in substantial costs and diversion of management's attention and resources.

Increasing government regulation could limit the market for, or impose sales and other taxes on the sale of, our products and services.

As Internet commerce evolves, we expect that federal, state or foreign agencies will adopt regulations covering issues such as user privacy, pricing, taxation of goods and services provided over the Internet, and content and quality of products and services. It is possible that legislation could expose companies involved in electronic commerce to liability, which could limit the growth of electronic commerce generally. Legislation could dampen the growth in Internet

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usage and decrease its acceptance as a communications and commercial medium. If enacted, these laws, rules or regulations could limit the market for our products and services.

### ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

We develop products in the United States and market our products in North America and, to a lesser extent, in Europe and the rest of the world. As a result, our financial results could be affected by factors such as changes in foreign currency rates or weak economic conditions in foreign markets. Because the majority of our revenues are currently denominated in U.S. dollars, a strengthening of the dollar could make our products less competitive in foreign markets.

#### INTEREST RATE RISK

We have an investment portfolio of money market funds and fixed income certificates of deposit. The fixed income certificates of deposit, like all fixed income securities, are subject to interest rate risk and will fall in value if market interest rates increase. We attempt to limit this exposure by investing primarily in short-term securities. In view of the nature and mix of our total portfolio, a 10% movement in market interest rates would not have a significant impact on the total value of our portfolio as of June 30, 2002.

## PART II. OTHER INFORMATION

### ITEM 1. Legal Proceedings

In November 2001, the Company and certain of its officers and directors were named as defendants in a class action shareholder complaint filed in the United States District Court for the Southern District of New York, now captioned, *In re Extensity, Inc. Initial Public Offering Securities Litigation*. In the complaint, the plaintiffs allege that the Company, certain of its officers and directors and the underwriters of its initial public offering ("IPO") violated the federal securities laws because the Company's IPO registration statement and prospectus contained untrue statements of material fact or omitted material facts regarding the compensation to be received by, and the stock allocation practices of, the IPO underwriters. The plaintiffs seek unspecified monetary damages and other relief. Similar complaints were filed in the same court against hundreds of other public companies that conducted IPOs of

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their common stock since the mid-1990s (collectively, the "IPO Lawsuits").

On August 8, 2001, the IPO Lawsuits were consolidated for pretrial purposes before United States Judge Shira Scheindlin of the Southern District of New York. Judge Scheindlin held an initial case management conference on September 7, 2001, at which time she ordered, among other things, that the time for all defendants to respond to any complaint be postponed until further order of the court. Thus, the Company has not been required to answer the complaint, and no discovery has been served on the Company.

In accordance with Judge Scheindlin's orders at further status conferences in March and April, the appointed lead plaintiffs' counsel filed amended, consolidated complaints in the IPO Lawsuits on April 19, 2002. Defendants then filed motions to dismiss the IPO lawsuits on July 1 and July 15, 2002, as to which the Court does not expect to issue a decision until at least November 2002. The Company believes that this lawsuit is without merit and intends to defend against it vigorously.

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### ITEM 2. Changes in Securities and Use of Proceeds

- a. Not applicable.
- b. Not applicable.
- c. Not applicable.
- d. Not applicable.

### ITEM 3. Defaults Upon Senior Securities

None.

### ITEM 4. Submission of Matters To a Vote of Security Holders

The Company's annual meeting of stockholders was held on May 31, 2002 (the "Annual Meeting"). The following matters were voted upon at the Annual Meeting:

Proposal 1 - To elect directors to hold office until 2003 Annual Meeting of Stockholders and until their successors are elected.

|                        | For<br>--- | Withheld Authority<br>----- |
|------------------------|------------|-----------------------------|
| Robert A. Spinner      | 21,485,121 | 66,674                      |
| Sharam I. Sasson       | 21,529,848 | 21,947                      |
| Christopher D. Brennan | 21,483,448 | 68,347                      |
| John R. Hummber        | 21,431,275 | 120,520                     |
| David A. Reed          | 21,431,448 | 120,347                     |
| Ted E. Schlein         | 21,484,048 | 67,747                      |

Proposal 2 - To ratify the selection of PricewaterhouseCoopers LLP as independent auditors of the Company for its fiscal year ending December 31, 2002.

|  | For | Against | Abstain |
|--|-----|---------|---------|
|--|-----|---------|---------|

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|            |        |       |
|------------|--------|-------|
| ---        | -----  | ----- |
| 21,483,558 | 61,010 | 7,227 |

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ITEM 5. Other Information

In accordance with Section 10A(i)(2) of the Securities Exchange Act of 1934, as added by Section 202 of the Sarbanes-Oxley Act of 2002 (the "Act"), we are required to disclose the non-audit services approved by our Audit Committee to be performed by PricewaterhouseCoopers LLP, our external auditor. Non-audit services are defined in the Act as services other than those provided in connection with an audit or a review of the financial statements of a company. The Audit Committee has not approved the engagement of PricewaterhouseCoopers LLP for any non-audit services.

ITEM 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibits 10.11.1, 10.14 and 99.1 are filed as updates to the exhibit index included in the Company's Form 10-K filed with the SEC on April 1, 2002 (File No. 000-28897).

Exhibit 10.11.1 Extensity, Inc. Amended and Restated 2000 Non-statutory Stock Option Plan.

Exhibit 10.14 Extensity, Inc. Executive Change of Control Severance Benefit Plan.

Exhibit 99.1 - Certification by Chief Executive Officer and Chief Financial Officer.

None.

(b) Reports on Form 8-K:

None.

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SIGNATURE

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

August 14, 2002

EXTENSITY, INC.

By /s/ Kenneth R. Hahn  
Chief Financial Officer (Principal Financial  
and Accounting Officer)

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