VERTICALNET INC
Form 10-K
March 31, 2003
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2002

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________

Commission File Number 000-25269

VERTICALNET, INC.

Pennsylvania	**23-2815834**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

400 CHESTER FIELD PARKWAY
MALVERN, PENNSYLVANIA 19355

610-240-0600

Securities registered pursuant to Section 12(b) of the act: NONE

Securities registered pursuant to Section 12(g) of the Act:

COMMON STOCK

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
x	o

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

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes	No
o	x

As of March 20, 2003, the aggregate market value of the Common Stock held by non-affiliates of the registrant was $6,349,253. Such aggregate market value was computed by reference to the closing sale price of the Common Stock as reported on The Nasdaq Stock Market on such date. For purposes of making this calculation only, the registrant has defined affiliates as including all officers, directors and beneficial owners of more than five percent of the Common Stock of the Company.

The number of shares outstanding of the registrant s common stock as of March 20, 2003 was 13,710,685**.**

DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III of this report, to the extent not set forth herein, is incorporated by reference from the registrant s definitive proxy statement relating to the annual meeting of shareholders to be held on June 18, 2003, which definitive proxy statement shall be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this report relates.

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PART IV

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

The information in this report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Any statements contained in this report that are not statements of historical fact may be deemed forward-looking statements. Words such as may, might, will, would, should, could, project, estimate, pro forma, predict, potential, strategy, anticipate, plan expect and words of similar expression (including the negative of any of the foregoing) are intended to identify forward-looking statements. Additionally, forward-looking statements in this report include statements relating to the design, development and implementation of our products; the strategies underlying our business objectives; the benefits to our customers and their trading partners of our products; our liquidity and capital resources; and the impact of our acquisitions and investments on our business, financial condition and operating results.

Our forward-looking statements are not meant to predict future events or circumstances and may not be realized because they are based upon current expectations that involve risks and uncertainties. Actual results and the timing of certain events may differ materially from those currently expected as a result of these risks and uncertainties. Factors that may cause or contribute to a difference between the expected or desired results and actual results include, but are not limited to, the availability of and terms of equity and debt financing to fund our business; our reliance on the development of our enterprise software business; our ability to continue to remain listed on the Nasdaq Small-Cap Market; competition in our target markets; economic conditions in general and in our specific target markets; our ability to use and protect our intellectual property; and our ability to attract and retain qualified personnel, as well as the risks discussed in the section of this report entitled Factors Affecting our Business Condition. Given these uncertainties, investors are cautioned not to place undue reliance on our forward-looking statements. We disclaim any obligation to update these factors or to announce publicly the results of any revisions to any of the forward-looking statements contained in this report to reflect future events or developments.

INFORMATIONAL NOTE REGARDING PRIOR STOCK SPLITS

Information in this report has been adjusted to reflect three separate stock splits of our common stock. A two-for-one stock split was effected on August 20, 1999 and another two-for-one stock split was effected on March 31, 2000. A one-for-ten reverse stock split was effected on July 15, 2002. All references to shares and per share amounts have been adjusted retroactively for these splits.

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PART I

Item 1. ***Business***

Verticalnet, Inc., which was incorporated on July 28, 1995 under the laws of Pennsylvania, is referred to throughout this report as Verticalnet , the Company , the registrant , we , us or through similar expressions.

We are a provider of collaborative supply chain solutions that enable companies to drive costs and inventory out of their supply base through more effective sourcing and supplier collaboration. With a comprehensive set of collaborative supply chain software applications including spend analysis, strategic sourcing, collaborative planning and order management, we offer a broad integrated supply chain solution.

With the completion of the Atlas Commerce, Inc. (Atlas Commerce) acquisition in December 2001 and the sale of our Small/Medium Business (SMB) unit (formerly referred to as Verticalnet Markets) in June 2002, we have completed the business transformation from our origins as an operator of online public vertical communities to a business solely focused on delivering sourcing and supply chain software and services to enterprise customers. See Management s Discussion and Analysis of Financial Condition and Results of Operations - Company Overview for a discussion of the significant changes in our business in 2002.

Collaborative Supply Chain Solutions

Our collaborative supply chain solutions enable companies and their entire network of business partners to reap the benefits of working together and sharing information. Verticalnet® Strategic Sourcing, Collaborative Planning, and Order Management enable companies to more effectively manage the Supply Management processes resulting in better visibility, reduced cost, lower inventory and streamlined administrative effort.

Our software is sold based on traditional license and maintenance agreements as well as through a newly introduced monthly subscription model. Under a monthly subscription plan, a customer s software investment is timed more closely with project benefits allowing projects to rapidly become self-funding. Additionally, by instituting monthly subscription pricing, Verticalnet prospects can often afford to pay for the software out of their operating budgets, rather than having to justify a capital expenditure.

Our typical customer will purchase one or several components of our software combined with implementation services. Our typical customer often adds additional functionality over time and often contracts with Verticalnet for additional implementation services support. In a number of strategic accounts, customers have contracted with Verticalnet to develop unique functionality specific for their requirements. In these cases, Verticalnet charges for specific development resources to build, test, and support these specific customer requirements.

We expect that our future revenue model will reflect a mix of software license, software subscription, implementation services, and development support services and that our customer revenue model will be less characterized by one-time large up-front fees and more by a customer lifetime value model where our relationships will extend for longer sustained periods. Verticalnet s goal is to build long-term relationships with customers, and to help our customers solve a broad set of supply chain problems over the life cycle of the relationship.

Competitive Advantage

Over the past several years, we have developed a suite of integrated, multi-enterprise software applications that co-exist with the existing information technology (IT) infrastructures of our customers. We believe our applications are more effective, as well as faster and easier to implement, than those of our competitors. Compared to other niche software providers, we believe our broad product footprint offers a competitive advantage. Compared to larger software companies, our business model of delivering self-funding projects through low, monthly subscription fees gives us a cost advantage.

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We believe our solutions provide the following benefits:

Visibility across the enterprise;

Large companies have a difficult time understanding where their money is being spent. Corporate spending information is locked in disparate purchasing, payables, and ERP systems across multiple divisions, locations, and geographies. Our software provides insight into enterprise spending patterns and enables large companies to make more intelligent purchasing decisions.

Ease of Use;

Our software is designed to be used and administered by business professionals, requiring minimal support or intervention from the IT department

Non-intrusive:

Our software extends the value of a company s existing supply chain and enterprise resource planning systems to include supply chain trading partners. Our non-invasive solutions help businesses achieve the full value they may not have been able to achieve using their existing systems, without disrupting the current systems.

Fast:

Implementation of our software ranges from two to six months.

With rapid implementation of our solutions, we can provide a more rapid return on the investment in our software.

Secure and Scalable:

Scalable technology, which a customer has used to connect over 10,000 of its buyers and suppliers at one time.

Built-in security rules ensure that information is seen only by the trading partners who are supposed to have access to it, and in the right format, language and currency.

Multi-enterprise:

Extensive sharing of data and business processes among and across businesses.

Inexpensive integration through the Internet -- no software is required for trading partners. Our system is available throughout the world using a standard web browser.

Value Proposition

Our solutions can deliver measurable, sustainable value to our customers. We believe our applications improve both our customers financial performance, product quality and customer satisfaction:

Costs of materials can decrease because of more effective purchasing and reduced inventory obsolescence write-offs due to better supply planning.

Administrative costs can decrease because of increased automation, reduction in sourcing, planning, and order cycle-times, and a reduction in planning and order errors.

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Product quality can increase due to improved supplier selection and performance.

Customer satisfaction can increase due to higher order-fill rates, on-time deliveries and a reliable supplier base.

Our Solutions

We offer three collaborative supply chain solutions: strategic sourcing, collaborative planning and order management. We have designed each one to address a specific set of supply chain challenges.

Verticalnet® Strategic Sourcing

Our strategic sourcing solution helps an enterprise analyze all of its purchasing -- across disparate divisions, locations and information systems. Our software highlights areas where companies can save money and also helps them identify and negotiate with suppliers. Additionally, our strategic sourcing solution enables our customers to measure and report on supplier performance, savings and other pertinent aspects of the sourcing process. Companies that implement our strategic sourcing solution can save on direct and indirect materials purchases.

Our solution has easy-to-use analytical reports, charts, and graphs to make it simple for procurement and financial professionals to aggregate spend across divisions, suppliers, and locations. We also deliver on-line sourcing mechanisms that help an enterprise complete faster sourcing cycles among broader sets of suppliers to increase competition for selecting suppliers, to analyze bids and to negotiate contracts. Finally, our software helps customers manage the performance of their supplier base and procurement organization so they can maximize the performance of their suppliers and contracts to realize their full value.

We offer a full suite of strategic sourcing capabilities. We believe that offering a full suite separates us from most solutions that are targeted at narrow sourcing problems. We offer strategic sourcing that serves as a starting point for enhancing the value of the collaborative supply chain.

Our applications enable the customer to approach the strategic sourcing process in three steps, designed to bring them continuous improvement through better sourcing decisions and more proactive sourcing behavior:

Identify savings, through our Spend Analysis solution

Realize savings, through our Sourcing Events solutions

Maintain savings, through our Sourcing Performance Analysis solution

Identify Savings

Our software enables procurement professionals and executives to see and analyze spend information across the entire enterprise. Verticalnet® Spend Analysis aggregates and normalizes spend information from multiple systems, allowing robust spend analysis without disrupting a customer s existing information technology infrastructure. We believe the benefits of this application include the following:

A single view of spend activities across the entire enterprise

On-demand access to timely spend data -- providing new cost structure insights, and enabling faster, more efficient sourcing cycles

Rapid identification of time sensitive cost savings opportunities

Ability to monitor supplier price/cost performance

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Ability to maintain divisional data integrity (naming conventions, stock keeping unit numbering) while gaining enterprise visibility

No changes to existing enterprise resource planning and/or legacy systems

Verticalnet® Spend Analysis provides the insight and analytics to measure ongoing purchasing behavior, resulting in optimized sourcing decisions. We include reporting and analytical capabilities with our Spend Analysis solution. This provides our customers with the ability to see where and how they are spending throughout the world, identify supply management problems, highlight opportunities to reduce costs, support supplier negotiations, monitor savings, and measure supply management effectiveness.

Realize Savings

We developed Verticalnet® Sourcing Events to help customers realize savings by automating their sourcing business processes and providing most of their sourcing alternatives, from auctions and catalogs to sophisticated online negotiations among multiple parties. These include: request for information (RFI), requests for quotation (RFQ), request for proposal (RFP), auction, structured negotiations, bid analysis, and contract awarding. We support sourcing processes for indirect goods, direct materials, and finished goods. Our customers can create value by effectively communicating requirements to potential suppliers, then negotiating the best strategic terms to minimize total costs.

Our software offers the ability for our customer s authorized suppliers to gain visibility into any request for quotation or sourcing, even for products that they may not currently be selling to the company. Our technology enables seamless management of suppliers in a sourcing community, allowing for any qualified supplier to participate in any sourcing event. We believe this increases the speed with which sourcing events can be completed, and leads to participation by a greater number of potential suppliers, which delivers significant potential cost savings for our customers.

Maintain Savings

After sourcing cycles are complete, Verticalnet® Sourcing Performance Analysis helps a customer s organization monitor and manage the performance of its supplier base. Sourcing Performance Analysis features include supplier scorecards and contract management. Our flexible supplier scorecard solution allows a customer to collect supplier performance information from disparate enterprise systems and create scorecards to measure supplier performance. Supplier scorecards include company-specific performance criteria, such as pricing, service levels, quality, and on-time shipments. Supplier scorecards also include weightings for each criterion, resulting in an overall supplier rating. A customer can also track supplier performance against historical data to examine trends in supplier performance.

Our collaborative capabilities allow suppliers to log in over the Internet on a standard web browser and view their own scorecard information as allowed by their authorized profile. This benefits our customer by facilitating corrective action planning for under-performing suppliers and improving overall service levels. Supplier performance ratings become part of the sourcing process, aiding supplier selection and negotiation for future sourcing cycles. Verticalnet® Sourcing Performance Analysis can help our customers continue to maintain the savings they generate through the sourcing cycle and foster better relationships with their supplier community.

Verticalnet® Collaborative Planning

Our collaborative planning solution communicates changes in market demand throughout the supply chain on a real-time basis, increasing information visibility and velocity across multiple layers of the supply chain. Instead of waiting weeks for information to flow through multiple planning systems, supply chain partners receive and can react to changes immediately, revising production plans and coordinating with their suppliers to optimize production and customer service. Everyone within an extended supply chain has access to timely, relevant, critical information. Traditionally, organizations deal with stagnant information by holding excess inventory. Our collaborative planning solution gives companies and their suppliers access to accurate and timely information that they can use to reduce excess inventory levels.

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Our solution helps an enterprise work more effectively with its trading partners through the sharing of:

- Real time demand data
- Demand forecasts
- Schedules
- Inventory plans
- Inventory positions
- Production plans

We designed Verticalnet® Collaborative Planning for enterprises that recognize the need to shift their focus from internal planning and demand forecasting to collaborative planning and improved response to actual changes in their customer demand. Our solution enables signals of changes in demand to move quickly back through the supply chain. An enterprise can use the demand plans collected from its customers to create supply plans with the enterprise s vendors and contract manufacturers. This collaborative planning allows the enterprise to reduce both its raw materials and its finished goods inventories and eliminate stock-outs that can cause lost sales and costly production delays.

Verticalnet® Order Management

Our order management solution enables companies to ensure that the right amount of the right products and materials gets to the right place at the right time - from simple catalog eProcurement to the optimization of complex, global supply chain processes such as outsourced manufacturing, vendor-managed inventory, and multi-currency, multi-company order management. Our order management software provides visibility into orders across the extended supply chain and can help companies improve the time it takes to fill their orders and reduce the cost of their order processing and materials.

Our solution gives an enterprise the ability to send documents -- purchase orders, invoice information, or inventory tracking notices -- to the right trading partners in real-time, which can cut weeks out of the ordering process. Our software can automatically segment orders that impact multiple suppliers, with each supplier only receiving and having visibility to the information relating to its products or services.

As supply chains become increasingly complex, businesses must work with multiple tiers of suppliers, contract manufacturers, and distribution and logistics partners. Businesses continue to implement more complicated supply chain strategies to improve their supply chain efficiency, such as multi-channel selling, outsourced packaging and manufacturing, and vendor-managed inventory. This leads to increased difficulty and complexity for enterprises in managing orders, logistics, and financial cash flows. Increasing supply chain complexity leads to several business challenges including the need to manage inventory at each tier of the supply chain, the challenge of lost purchasing power due to outsourcing, and the difficulty of tracking orders and goods as they move across the supply chain.

We believe our order management software is particularly suited for complex supply chains. Our solution helps our customers obtain the optimum benefit from their supply chain strategies. Our solution can improve visibility into the process of moving orders, materials, and financial settlements among the multiple parties in the extended supply chain.

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Services

We offer a full complement of consulting, integration, custom development, training, and customer support services. Our team is committed to delivering a quick and efficient implementation with seamless integration and a smooth operation so that our customers can achieve their targeted return on investment.

Consulting and Integration Services

Consulting and integration services help customers plan, implement and manage our software so they achieve their business objectives. At the heart of our consulting services are straightforward processes and tools that make software implementations smooth and efficient. The methodology approaches implementation in well-defined, manageable phases -- rolling out categories, suppliers and customers over discrete intervals and targets the first actual customer transaction generally in less than 90 days.

Our project teams are experienced at building and implementing private exchanges for Global 2000 companies. Our teams are focused with clearly defined goals, roles and responsibilities.

Our project teams are flexible. Customers may choose to use our consulting services exclusively, or use our services with their own internal resources or in association with our network of systems integration and consulting partners. Our partners are trained and certified on our products. They provide consulting, design, and installation services to ensure that all parts of the solution are seamlessly integrated into a scalable, well-performing system. Our consulting partners include BearingPoint, Cap Gemini Ernst & Young, and Deloitte Consulting.

Custom Development

Verticalnet offers custom development for customers that desire to build additional capabilities into Verticalnet s applications. Verticalnet s Solution Center works with clients to define custom development requirements and build the required functionality on top of our Collaborative Supply Chain Foundation. Often, new capabilities developed for customers can be built into future versions of the Verticalnet software.

Verticalnet s Collaborative Supply Chain Foundation was built to be flexible and extensible. Many of our customers find that their complex supply chain problems can be solved by taking advantage of the features of the Foundation. Verticalnet s Solution Center was developed to enable our customers to build out additional functionality to meet these complex requirements. Our Solution Center approach allows Verticalnet to complete customization projects more quickly and cost effectively than internal IT organizations or traditional custom development firms. Additionally, the resulting custom developed applications are fully integrated with, and built on the same data model as, the customer s existing Verticalnet implementation.

Training

Our training services help organizations develop the knowledge and skills required to successfully deploy, maintain and use our products. Participants engage in discussions, work on projects and gain hands-on experience using our software. We tailor our training to meet the needs of the customer. We can deliver training in a variety of formats, including:

Pre-designed courses

Train-the-trainer instruction

On-site instructor-led training

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Customer Support

Our customer support services provide all the information, tools and assistance customers need, including support representatives to respond to service requests ranging from simple technical inquiries to mission critical problems.

Our Technology

Collaborative Supply Chain Foundation

All of our applications are powered by our patent-pending Collaborative Supply Chain Foundation technology that enables collaboration among companies and across the supply chain. Our foundation operates in a non-intrusive layer above a company s existing enterprise resource planning and enterprise systems. We designed our technology to leverage and drive additional return on a company s existing information technology investments.

In developing our collaborative supply chain solutions, we set the following goals:

- Provide visibility into critical business information for the network of businesses that make up the extended enterprise
- Enable automated multi-enterprise business processes to reduce the costs of supply chain functions such as sourcing, planning and order management

To meet those goals, we designed our collaborative supply chain solutions on a technology foundation that overlays and leverages our customers existing enterprise systems. Our software provides a dashboard for business users to monitor and analyze critical supply management information.

Our foundation provides security and confidentiality for the external trading partners that are incorporated into a company s collaborative supply chain. Traditional enterprise systems provide some security, but cannot handle the complexity of multi-enterprise access without significant modifications. We developed our technology so that confidential business information is only viewable by those companies that are authorized to do so.

Analytical Services

We offer patent pending analytical tools and scorecards built on our collaborative supply chain foundation. Our customers management teams use analytical tools and reports to measure and control their businesses. In a multi-enterprise world, there are few tools that allow multiple companies to work together and set joint targets, measure performance, share reports and scorecards with trading partners, and develop improvement plans. Our solution provides tools that can be viewed by multiple enterprises -- with security built in -- so that each company only sees what it is supposed to see.

Application Services

We designed our application services to address the difficulty inherent in collaborative supply chains where each trading partner needs to access the same system and the same information in different languages simultaneously. Our solution allows the co-existence of synchronized, multi-language environments around the world on a single system. We use individual user profiles to identify which language each user sees. Most solutions that support multiple languages can support only one language on the system at a time. Our solution also supports different date formats and allows trading partners to utilize their own planning horizons on shared plans.

Member Enablement

We designed our patent pending solutions to support multiple ways for a company and its trading partners to connect their internal systems. In a multi-enterprise world, the technology challenge is to connect thousands of companies with different ERP systems, data formats and communication protocols. Our technology features connectors that handle industry standard data formats and communication protocols to integrate with back-end applications. Trading partners can connect through an Internet connection, XML connection, EDI, email, fax, pager, or custom services. Our foundation also includes a library of industry standard transaction sets designed to support integration of trading partners systems with minimal effort.

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Business Process Management

Our software is designed so that trading partners require no software to connect to our customers through the Internet. By automating business processes, more trading partners are able to easily participate across the full breath of the solution. When action is required, such as updating a plan or committing to a forecast, the trading partner moves directly from their email into the system to complete the required action.

Our solution has a powerful patent pending rules-based transaction processing engine that can dynamically route documents, update documents, create new documents and process workflow events without human intervention. Many systems rely on human action to move from step to step, resulting in information moving slowly through the supply chain. Our technology automatically generates information among trading partners.

This machine-to-machine communication can reduce administrative costs, reduce inventory cycle times and eliminate human error for processes that follow standard business rules.

Catalog Management

Using our solutions, companies throughout the supply chain can maintain catalogs in their own format, with their own hierarchy structure and numbering system. While some businesses use the standard UNSPSC system to categorize their products, most companies use some form of their own product hierarchies, product numbering systems and supplier identification scheme. We offer simple, patent-pending mapping tools that allow a business in the supply chain to maintain its catalog data in its own format, yet that information can be viewed by other businesses in the supply chain in their own formats. We believe this permits greater trading partner participation than enterprise-centric systems. When connecting to an extended enterprise, or a customer s e-procurement system under an enterprise-centric system, the trading partner will have to conform to standards that are not their own. This may require significant time and investment or force the trading partner not to participate.

Contracts and Pricing Management

Our contracts and pricing management capabilities are flexible. We designed them for multi-entity use because businesses with multiple divisions, locations and disparate enterprise systems have difficulty leveraging national or global contracts with suppliers or customers, because of differences in freight, taxes, currency, discounts and rebates. For example, if our customer negotiated a national contract with a supplier, but freight calculations are different for locations in Alaska and Hawaii, our foundation treats this as a single contact with exceptions for ship-to locations in Alaska and Hawaii. Most enterprise-centric systems require a business to set up individual contracts for these locations, increasing complexity, and diluting some of the benefits of a national contract.

Platforms

We believe our solutions are highly scalable due to the separation of various layers. Our solution has supported 1,200 buyers completing more than $1 billion in transactions with over 12,000 suppliers. We designed the architecture of our solutions to be available to a customer s supply chain trading partners completely over the Internet. No software is required for trading partners because they can access the extended enterprise through the Internet. We believe this can significantly lower the cost of their participation and their maintenance costs.

The operating system for our software is based upon standard open technologies, allowing our solution to be deliverable on both Microsoft and Unix based platforms.

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Sales and Marketing

Our sales operation headquarters are in Malvern, Pennsylvania. Our direct sales organization focuses on securing software licenses or subscriptions for our collaborative supply chain solutions with large manufacturing companies, typically with over $750 million in revenues. Account executives have deep experience in enterprise software sales, including sales experience from SAP, Accenture and SCT. Our direct sales force is teamed with pre-sales consultants that work with prospects to select the proper applications to meet customer requirements and deliver the greatest value.

We also use indirect sales channels, such as third-party alliances, to market our solutions, and increase the market penetration of our solutions through joint marketing and sales activities. Such relationships allow us to extend the reach of our sales efforts without increasing headcount.

We support our sales activities by conducting a variety of marketing programs and participate in industry conferences. We maintain relationships with recognized industry analysts including AMR Research, Gartner and Aberdeen. These firms advise our target client base as well as provide us with critical feedback into our product management process. We also conduct lead-generation programs including telesales, web seminars, advertising, direct mail, e-mail marketing, public relations and ongoing client communication programs.

Proprietary Rights

We regard our software as proprietary and rely on a combination of trade secret, patent, copyright and trademark laws, license agreements, confidentiality agreements with our employees and nondisclosure and other contractual requirements imposed on our clients, consulting partners and others to help protect proprietary rights in our products. We distribute our collaborative supply chain applications under software license agreements, which typically grant clients nonexclusive, nontransferable licenses to our products and have perpetual terms unless terminated for breach. Under such typical license agreements, we retain all rights to market our products.

Use of the licensed software is usually restricted to clients internal operations and to designated users. Use is subject to terms and conditions that prohibit unauthorized reproduction or transfer of the software. We also seek to protect the source code of our software as a trade secret and as an unpublished, copyrighted work.

Research and Development

We direct our efforts in research and development to new products, enhancements of the capabilities in existing products, and expansion of our collaborative supply chain capabilities. Our internal research and development team has developed all of our current products, although we obtained some underlying technology through acquisition. In developing new products or enhancements, we work closely with current and prospective clients, as well as with industry experts, to ensure that our products address critical supply chain needs of today s businesses. We believe that this collaboration is necessary to develop and improve our software and products. Our product group works closely with our marketing, sales, and services groups to develop products that meet real customer needs. As of March 20, 2003, our research and development staff consisted of 25 employees.

Competition

The markets for our solutions are highly competitive. Our competitors are diverse and offer a variety of solutions targeting various segments of the extended supply chain as well as the enterprise as a whole. Some competitors, such as enterprise resource planning companies and supply chain management companies, compete with suites of applications designed to offer out-of-the-box integration, while most of our competitors offer point solutions designed specifically to target particular functions or industries. We bring together our applications in an integrated environment to capture the advantages of both approaches, and to offer our customers a one-stop shop for their collaborative supply chain needs. More specifically, we compete with:

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Large enterprise resource planning (ERP) software vendors, including Oracle, Peoplesoft and SAP, who have added or are attempting to add capabilities for strategic sourcing or business-to-business collaboration to their transaction system products.

Supply chain management (SCM) companies, including i2 and Manugistics, who compete principally with our supply chain management applications.

e-Sourcing solution providers, such as Frictionless Commerce, Emptoris and Ariba, that compete principally with our strategic sourcing applications.

Other point solution providers, including Softface, Informatica and SAS, that provide analytical products that compete with our Spend Analysis product.

Internal development efforts by corporate information technology departments.

We believe that the principal competitive factors affecting our market include breadth and depth of solution, product quality and performance, customer service, core technology, product features, ability to implement solutions, value of solutions, and a base of reference customers. Although we believe that our solutions currently compete favorably with respect to these factors, our market is evolving rapidly, and we may not be able to maintain our competitive position against current and potential competitors, especially those with greater financial, marketing, service, support, technical and other resources.

SMB Business

In June 2002, we completed the sale of certain of the assets of the SMB unit to Corry Publishing for $2.35 million in cash consideration, plus up to an additional $6.5 million as an earn-out over the four-year period after the closing date. Additionally, during the quarter ended June 30, 2002, other assets in the SMB unit were sold under a separate agreement. Together, the transactions substantially finalized the operations of the SMB unit as part of Verticalnet.

Employees

As of March 20, 2003, we had 65 employees. We consider our relationship with our employees to be good. None of our employees are covered by collective bargaining agreements.

Executive Officers

The following table sets forth the name, age and position of each person who was serving as an executive officer as of March 20, 2003.

Name	Age	Position
Nathanael V. Lentz	40	President and Chief Executive Officer
Gene S. Godick	37	Executive Vice President and Chief Financial Officer
Christopher G. Kuhn	51	Vice President, General Counsel and Secretary

Set forth below is biographical information about each of our executive officers.

Nathanael V. Lentz has served as our President and Chief Executive Officer since November 2002. He was our Senior Vice President of Strategy and Marketing from August 2000 to November 2002, during which time he had responsibility for guiding our transition from an operator of internet-marketplaces to a provider of collaborative supply chain solutions. Prior to that, Mr. Lentz was a Vice President and Partner of Mercer Management Consulting, where he was employed from September 1991 to May 1998 and January 1999 to August 2000. While at Mercer, Mr. Lentz managed the San Francisco office and was a leader in their Global Process Industries and E-Commerce

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Practices. From May 1998 to November 1998, he was employed as Vice President of Strategic Development at CMC Industries, an Electronic Manufacturing Services company located in Santa Clara, CA. Mr. Lentz received his MBA from Stanford University where he was an Arjay Miller scholar and a B.A. from Brown University.

Gene S. Godick - has served as our Chief Financial Officer since February 2003. Mr. Godick also previously served as our Chief Financial Officer from June 1998 until October 2001 and as a financial consultant to the Company from November 2002 to February 2003. For the period from December 2001 through June 2002, Mr. Godick served as the Chief Financial Officer of TargetRx, Inc., a privately owned company based in Horsham, Pennsylvania. From 1997 until 1998 he worked as a senior manager at KPMG LLP in their information, communications and entertainment practice, with a focus on high technology companies. Prior to joining KPMG, Mr. Godick was President and Chief Financial Officer of Industrial Construction, Inc., a privately owned environmental remediation firm, from 1994 to 1997. From 1987 until 1994, Mr. Godick was an accountant and manager for Arthur Andersen LLP s Enterprise Group, which provided services to emerging growth technology and software companies. Mr. Godick received a B.S. from Villanova University and is an inactive Certified Public Accountant in the state of Pennsylvania.

Christopher G. Kuhn - has served as our Vice President, General Counsel and Secretary since October 2002. From February 2000 through October 2002, he was Verticalnet s Vice President of Legal Affairs and Assistant Secretary. From December 1998 through February 2000 he was General Counsel of the Company. Prior to that, he was an attorney with the law firm of Silberman & DiFilippo from 1989 to 1998. Mr. Kuhn received a B.A. from West Chester State College and a J.D. from the Delaware Law School.

Website Disclosures

We maintain a website at www.verticalnet.com and make available free of charge on this website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after the Company electronically files such material with, or furnishes it to, the SEC. The material on our website is not part of this report.

Item 2. ***Properties***

Our corporate headquarters is located in Malvern, Pennsylvania. We maintain locations throughout the United States. The locations of these facilities, their respective size and lease status are as follows:

Location	Type of Facility	Size (in sq/ft)	Ownership Status
Malvern, Pennsylvania	Headquarters	4,800	Leased
Endicott, New York	Development	7,700	Leased
San Francisco, California	Office	9,500	Leased
Washington, DC	Office (a)	3,200	Leased
Irving, Texas	Office (a)	2,100	Leased

(a) We are currently subleasing these properties to unrelated third parties for $9,400 and $2,600 per month for the Washington, DC and Irving, Texas facilities, respectively.

Item 3. ***Legal Proceedings***

On June 12, 2001, a class action lawsuit was filed against us and several of our officers and directors in U.S. Federal Court for the Southern District of New York in an action captioned CJA Acquisition, Inc. v. Verticalnet, et al., C.A. No. 01-CV-5241 (the CJA Action). Also named as defendants were four underwriters involved in the

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issuance and initial public offering of our common stock in February 1999 -- Lehman Brothers Inc., Hambrecht & Quist LLC, Volpe Brown Whelan & Company LLC and WIT Capital Corporation. The complaint in the CJA Action alleges violations of Sections 11 and 15 of the Securities Act of 1933 and Section 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated there under, based on, among other things, claims that the four underwriters awarded material portions of the initial shares to certain favored customers in exchange for excessive commissions. The plaintiff also asserts that the underwriters engaged in a practice known as laddering, whereby the clients or customers agreed that in exchange for Initial Public Offering (IPO) shares they would purchase additional shares at progressively higher prices after the IPO. With respect to Verticalnet, the complaint alleges that the Company and its officers and directors failed to disclose in the prospectus and the registration statement the existence of these purported excessive commissions and laddering agreements. After the CJA Action was filed, several copycat complaints were filed in U.S. Federal Court for the Southern District of New York. Those complaints, whose allegations mirror those found in the CJA Action, include Ezra Charitable Trust v. Verticalnet, et al., C.A. No. 01-CV-5350; Kofsky v. Verticalnet, et al., C.A. No. 01-CV-5628; Reeberg v. Verticalnet, C.A. No. 01-CV-5730; Lee v. Verticalnet, et al., C.A. No. 01-CV-7385; Hoang v. Verticalnet, et al., C.A. No. 01-CV-6864; Morris v. Verticalnet, et al., C.A. No. 01-CV-9459, and Murphy v. Verticalnet, et al., C.A. No. 01-CV-8084. None of the complaints state the amount of any damages being sought, but do ask the court to award rescissory damages. All of the foregoing suits were amended and consolidated into a single complaint that was filed with the U.S. Federal Court on April 19, 2002. This amended complaint contains additional factual allegations concerning the events discussed in the original complaints, and asserts that, in addition to Sections 11 and 15 of the Securities Act, the Company and our officers and directors also violated Sections 10(b), 20(a) and Rule 10b-5 of the Exchange Act in connection with the IPO. In addition to this amended and consolidated complaint, the plaintiffs in this lawsuit and in the hundreds of other similar suits filed against other companies in connection with IPOs that occurred in the late 1990s have filed master allegations that primarily focus on the conduct of the underwriters of the IPOs, including our IPO. On October 9, 2002, the U.S. Federal Court for the Southern District of New York entered an order dismissing, without prejudice, the claims against the individual Verticalnet officers and directors who had been named as defendants in the various complaints. In February 2003, the District Court entered an Order denying a Motion made by the defendants to dismiss the actions in their entirety, but granting the Motion as to certain of the claims against some defendants. However, the District Court did not dismiss any claims against Verticalnet. We have retained counsel and intend to vigorously defend ourselves in connection with the allegations raised in the amended and consolidated complaint. In addition, we intend to enforce our indemnity rights with respect to the underwriters who are also named as defendants in the amended and consolidated complaint.

We are also party to various litigations and claims that arise in the ordinary course of business. In the opinion of management, the ultimate resolutions with respect to these actions will not have a material adverse effect on our financial position or results of operations.

Item 4. ***Submission of Matters to a Vote of Security Holders***

No matters were submitted to a vote of security holders during the fourth quarter of 2002.

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PART II

Item 5. ***Market for Registrant s Common Equity and Related Stockholder Matters***

Our common stock is traded on the Nasdaq Small-Cap Market under the symbol VERT. The following table sets forth, for the periods indicated, the range of the high and low closing sales prices of our common stock as reported by NASDAQ

		High	Low
Fiscal Year 2002			
	First Quarter	$ 17.30	$ 6.50
	Second Quarter	7.40	1.60
	Third Quarter	1.70	0.61
	Fourth Quarter	1.95	0.66
Fiscal Year 2001			
	First Quarter	$ 62.50	$ 16.20
	Second Quarter	32.90	13.40
	Third Quarter	21.60	3.60
	Fourth Quarter	20.90	3.40

The share price data set forth above reflects a one-for-ten reverse stock split approved by the board of directors. The commencement date for the reverse stock split was July 15, 2002.

At March 20, 2003, we had 899 shareholders of record.

We have never declared or paid any cash dividends on our common stock. We do not anticipate paying any cash dividends in the foreseeable future. We currently intend to retain future earnings, if any, to finance our operations and expand our business. Any future determination to pay cash dividends will be at the discretion of the board of directors and will be dependent upon our financial condition, operating results, capital requirements and other factors the board of directors deems relevant.

Item 6. ***Selected Financial Data***

The following selected consolidated financial data should be read in conjunction with the consolidated financial statements and the related notes thereto (see Item 8 of this report), as well as Management s Discussion and Analysis of Financial Condition and Results of Operations (see Item 7 of this report).

	Year Ended December 31,		
	2002	2001	2000
	(in thousands, except per share data)		
Consolidated Statement of Operations Data: (a):			
Revenues	$ 43,724	$ 36,119	$ 7,906
Net loss from continuing operations	(30,859)	(670,197)	(145,794)
Basic income (loss) per common share from continuing operations	$ 5.52	$ (69.92)	$ (18.17)
Diluted loss per common share from continuing operations	$ (2.56)	$ (69.92)	$ (18.17)

(a) Information for the years ended December 31, 1999 and 1998 is not relevant as the Company s sole business in those years is now presented as a discontinued operation.

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	As of December 31,				
	2002	2001	2000	1999	1998
	(in thousands)				
Consolidated Balance Sheet Data:					
Total assets	$ 18,453	$ 125,631	$ 923,284	$ 318,981	$ 12,343
Long-term debt, excluding current portion	7,293	22,255	45,287	116,750	5,352
Convertible redeemable preferred stock		102,180	94,760		
Total shareholders equity (deficit)	1,642	(91,339)	605,402	178,397	(276)

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion and analysis of our financial condition and results of operations should be read together with the consolidated financial statements and the related notes thereto appearing in Item 8 of this report. All share and per share amounts have been adjusted to reflect the reverse stock split that occurred in July 2002.

Company Overview

Verticalnet, through its subsidiaries, is a provider of collaborative supply chain solutions that enable companies and their supply and demand chain partners to communicate, collaborate, and conduct commerce more effectively. With a comprehensive set of collaborative supply chain software applications including spend management, strategic sourcing, collaborative planning, and order management, we offer a broad integrated supply chain solution delivered through a multiparty platform. With our completion of the acquisition of Atlas Commerce in December 2001 and the June 2002 sale of our SMB unit that operated and managed 59 industry-specific online marketplaces, we have completed a business transformation from our origins as an operator of online public vertical communities to a business solely focused on delivering supply chain solutions to enterprise customers.

With this transformation, the presentation of our consolidated statements of operations has been modified. Most significantly, the operations of the SMB unit are classified in discontinued operations for all periods presented. Also, the classification of our revenues and costs of revenues and expenses have changed, and certain overhead expenses previously categorized as general and administrative expenses have been allocated to the business functions receiving the benefits attributable to such expenses. These changes to the presentation of the statement of operations were made for all periods presented. We believe these changes will provide more clarity into the ongoing operations, and present a more traditional view of a software company s statement of operations.

Significant management actions were taken since the beginning of 2001 to complete the transformation from an operator of online public vertical communities to an enterprise software company. These actions include the following:

In January 2001, we completed the sale of our Verticalnet Exchanges to Converge. In April 2001, we restructured our agreement with Microsoft to focus on supplier enablement solutions. In October 2001, we restructured our license and services agreements with Converge as Converge changed strategic direction. In December 2001, we acquired Atlas Commerce in an effort to expand our product and customer base in the software business.

In June 2002, we completed the sale of certain assets of the SMB unit to Corry Publishing for $2.35 million in cash consideration, plus up to an additional $6.5 million as an earn-out over the four-year period after the closing date. Additionally, during the quarter ended June 30, 2002, other assets in the SMB unit were sold under a separate agreement. Together, the transactions substantially finalized the operations of the SMB unit as part of Verticalnet. The SMB unit has retroactively been presented as a discontinued operation for all periods presented.

With our transformation to an enterprise software business model complete, management has taken the following significant actions since June 2002 to restructure our balance sheet and improve the financial viability of our business:

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In June 2002, the Company completed the repurchase of all of its outstanding shares of Series A 6.00% convertible redeemable preferred stock due 2010, plus accrued dividends thereon, for a purchase price of $5.0 million, and cancelled a common stock purchase warrant, dated April 7, 2000. The effect of the transaction was a net increase to shareholders equity of $101.0 million.

In July 2002, we completed the repurchase of $13.85 million of our 5 1/4% convertible subordinated debentures due September 2004 for total consideration of $2.9 million. This consideration included $0.8 million, or 1,270,854 shares, in common stock consideration, and $2.1 million in cash consideration. Additionally, we made a payment for accrued but unpaid interest of $0.3 million, also in cash. In connection with the transaction, $0.2 million of deferred debt offering costs attributable to the portion of debt repurchased were written off against additional paid in capital. In addition, the Company also recorded a charge to operations of $2.9 million representing an inducement for conversion of the convertible debentures, in accordance with Statement of Financial Accounting Standards (SFAS) No. 84, Induced Conversions of Convertible Debt. The net effect on shareholders equity was an increase of $11.5 million. In December 2002, we completed the repurchase of $0.7 million of our 5 1/4% convertible subordinated debentures for total consideration of $0.1 million. We recognized a gain of $0.6 million in connection with the repurchase.

In September 2002, we completed the repurchase of the remaining 10% interest in Verticalnet Europe, B.V. that we did not own (the BV Shares), for consideration of $6.5 million in cash and 1,000,000 shares of common stock valued at $1.2 million (200,000 shares were previously issued in 2002 as partial payments toward the obligation, along with an additional $3.0 million payment). In connection with this settlement, the put and call agreement between Verticalnet and British Telecommunications Plc. (BT) was terminated. Separately, the Company and BT also agreed to terminate a Reseller Agreement between the parties, including a $1.5 million prepaid license obligation that was included in current liabilities on the consolidated balance sheet as of December 31, 2001. As a result of this settlement, the Company recorded a $4.8 million gain representing the difference between the fair value of the consideration issued in the settlement transaction and the carrying value of the amounts due BT.

Also in September 2002, the Company and its wholly-owned subsidiary, VNI Holdings, Inc. (VNI) entered into an agreement with another investor in Converge to sell all of the Company s equity interests in, and notes receivable from, Converge for cash consideration of approximately $1.9 million. At the first closing on September 30, 2002, VNI transferred the notes receivable and a portion of the Converge equity to the buyer and received the entire $1.9 million cash consideration. Under the terms of the agreement, at the second closing, which has not yet occurred, the Company is expected to transfer to the buyer all of the outstanding capital stock of VNI, which owns all of the Company s remaining equity interest in Converge. If the Company is not able to transfer the stock of VNI in accordance with the agreement, then the buyer has the right to require VNI to transfer the remaining Converge equity interests to the buyer and the Company will be required to refund approximately $0.1 million of cash consideration to the buyer. The buyer holds an irrevocable proxy to vote the Converge equity interests, and has no course of action available to it with regard to the second closing, other than as discussed above. For additional information on our relationship with Converge, see Sale of Verticalnet Exchanges (NECX) below.

We completed a goodwill impairment test as of September 30, 2002, under SFAS No. 142, Goodwill and Other Intangible Assets. This test requires a comparison of the fair value of a reporting unit with its carrying amount, including goodwill. We did not consider the market capitalization of the Company, which consists of only one reporting unit, to be representative of its fair value due to the volatility of the market price. Therefore, we estimated the fair value of the business based upon the amounts we could reasonably expect to realize in the sale of the assets of the business. As a result of this test, the Company recorded an impairment charge to goodwill of $27.6 million. Of this amount, approximately $21.6 million related to the December 2001 acquisition of Atlas Commerce and approximately $6.0 million related to the Company s acquisition of Isadra, Inc. (Isadra) in August 1999.

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In November 2002, the Company entered into a second amendment to the amended and restated subscription license agreement with Converge. This amendment eliminated the obligation of the Company to provide future Verticalnet products to Converge at no cost for the term of the original subscription license agreement. As there remained no further obligation by Verticalnet under the license agreement with Converge, the remaining deferred license revenue balance of $19.6 million was recognized during the fourth quarter of 2002. Since all amounts due under the amended and restated subscription license agreement had been collected, the revenue recognized did not represent additional cash inflows to the Company. This amendment did not alter the maintenance and support agreement between the Company and Converge.

In January 2003, the Company amended the lease agreement with its primary landlord resulting in an annual savings of $2.7 million of operating expenses and reducing the Company s off balance sheet obligations by $16.4 million, which consisted of both future minimum lease payment and related operations expenses. The amended agreement terminates the Company s financial obligation for the lease of the 700 Dresher Road and 300 Chester Field Parkway locations. Additionally, the agreement provides for occupancy of the 400 Chester Field Parkway premises until May 31, 2003 with options to continue the lease on a quarterly basis.

Since 2001, we have made the following changes to our executive management team:

In January 2001, we appointed Michael J. Hagan, our cofounder and chief operating officer at the time, to become our president and chief executive officer. Mr. Hagan resigned as president and chief executive officer in February 2002 and became chairman of the Board of Directors.

In February 2002, Kevin S. McKay, a former member of our board of directors, was appointed president and chief executive officer. In November 2002, Mr. McKay resigned as Verticalnet s president and chief executive officer and stepped down from the Company s board of directors. In February 2002, John A. Milana, former chief financial officer of Atlas Commerce, was appointed as Verticalnet s chief financial officer replacing interim chief financial officer, David Kostman. In November 2002, Mr. Milana resigned as Verticalnet s chief financial officer.

In November 2002, Nathanael V. Lentz, formerly Verticalnet s senior vice president of strategy and marketing, was appointed president and chief executive officer and became a member of our board of directors. In November 2002, Gene S. Godick, formerly Verticalnet s chief financial officer from June 1998 to October 2001, returned as a consultant at the request of Verticalnet s board of directors. In February 2003, Mr. Godick was appointed Verticalnet s executive vice president and chief financial officer.

In September 2002, the Company retained US Bancorp Piper Jaffray to assist the Company in exploring strategic alternatives including the possible sale of the business.

Atlas Commerce Acquisition

In December 2001, we acquired all of the outstanding capital stock of Atlas Commerce, a privately held software company that provided private exchange software and strategic sourcing applications. As a result of the acquisition, we accelerated our enterprise software business by offering an integrated collaborative sourcing solution that represents a combination of both companies technologies. Atlas Commerce s results of operations have been consolidated starting January 1, 2002. The aggregate purchase price was approximately $26.8 million, including transaction costs. The consideration included $3.5 million in cash, 1,430,571 shares of our common stock valued at approximately $19.5 million and issuance of employee options to purchase 163,007 shares of our common stock valued as of the date of acquisition at $1.4 million based on an independent valuation. Included in the stock consideration were 14,808 shares of our common stock that were issued to a former Atlas Commerce executive in January 2002. A portion of the value of the common stock given as consideration was reduced by an illiquidity discount ranging from 5% to 10% based on restrictions detailed in a registration and lock up agreement executed in connection with the transaction.

The Merger Agreement for the Atlas Commerce acquisition provided for a put option to Atlas Commerce s former common shareholders. These shareholders had the ability to put a maximum of approximately $1.1 million worth of our common shares back to us for cash. At the acquisition date the put arrangement covered 72,888 shares

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of our common stock and was recorded in temporary equity as of December 31, 2001, pursuant to the guidance in Emerging Issue Task Force (EITF) Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company s Own Stock. In August 2002, the Company completed the repurchase of 235,981 shares of our common stock from former shareholders of Atlas Commerce under the terms of the put agreement. The aggregate purchase price for the put shares was $1.0 million. These shares were retired upon repurchase. The effect of this transaction and the expiration of the put terms for the unexercised portion are reflected in the consolidated balance sheet as of December 31, 2002.

All of the goodwill ($21.6 million) related to this transaction was written off due to impairment in September 2002.

Restructuring and Asset Impairment Charges

During the year ended December 31, 2001, we announced and executed four major restructuring efforts designed to reduce overall costs and streamline operations. Our goals were to eliminate redundant positions and facilities primarily related to previous acquisitions that had not been fully integrated, to eliminate several unprofitable business initiatives, to improve our operating efficiency and margins, and to redefine the business as a software company.

The following table provides a summary by category and a roll-forward of the changes in the restructuring accrual for the year ended December 31, 2002 (in thousands):

	Accrual at December 31, 2001	Cash payments	Adjustments	Accrual at December 31, 2002
Lease termination costs	$ 4,763	$ (2,594)	$ 1,315	$ 3,484
Employee severance and related benefits	2,294	(2,856)	612	50
Other exit costs	25	(3)	(22)	
	$ 7,082	$ (5,453)	$ 1,905	3,534

Our aggregate restructuring and asset impairment charges for the year ended December 31, 2002 were approximately $29.1 million for continuing operations. Our cost cutting measures during the year ended December 31, 2002 included an aggregate work force reduction throughout the organization and various office facility closures. As of December 31, 2002, remaining accrued restructuring expenses of $3.5 million relates primarily to lease termination costs. These amounts are expected to adequately cover actual amounts to be paid. Differences, if any, between the estimated amounts accrued and the actual amounts paid will be reflected in operating expenses in future periods.

We intend to continue focusing on revenue growth, achieving profitability and reviewing our operations for cost-cutting opportunities that will improve our operating margins. We expect to continue to streamline our operations, including making additional headcount reductions if the revenues expected from our product and service offerings do not materialize.

We operate in an industry that is rapidly evolving and extremely competitive. Recently, many software businesses have experienced difficulty in raising capital necessary to fund operating losses and ongoing investments in strategic relationships. Valuations of public companies in the software sector have declined significantly since the first quarter of 2000. During the year ended December 31, 1999 and in the first quarter of 2000, we announced several acquisitions, the most significant of which was Tradeum, that were financed principally with shares of our common stock and valued based on the price of our common stock at that time. We regularly perform reviews to determine whether events or changes in circumstances indicate that the carrying value of the goodwill and other

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intangible assets may not be recoverable. As a result of these reviews during the year ended December 31, 2002, we recorded impairment charges of approximately $27.6 million for identifiable intangible assets and goodwill. Aggregate impairment charges of approximately $231.1 million during the year ended December 31, 2001 were related to the write-off of goodwill and other identified intangible assets associated with our Tradeum acquisition. We initially recorded an impairment in the second quarter of 2001 to reduce identifiable intangible assets and goodwill to their estimated fair value, which was based upon the valuation of comparable publicly held businesses. Subsequently in the fourth quarter of 2001, we recorded an additional impairment to write-off the remaining goodwill and identified intangibles. The decision to impair the remaining Tradeum goodwill was primarily based on our acquisition of Atlas Commerce in December 2001 and our decision to migrate to the Atlas Commerce platform.

During the years ended December 31, 2002 and 2001, we also recorded aggregate charges of approximately $11.6 million and $231.3 million, respectively, included in interest and other income (expense), net in the consolidated statement of operations, for impairments to our cost method, equity method and available-for-sale investments. These charges, for other than temporary declines in the fair value of our investments, were based on reviews of the market conditions and the assumptions underlying the operating performance and cash flow forecasts. This information was used in assessing the recoverability of our carrying values for the individual investments. Approximately $207.2 million of the impairment charges in 2001 were to write down our Converge investment, which was previously valued at $215.0 million (see Notes 5 and 9 to our consolidated financial statements). The impairment charge was based on independent valuations of our Converge investment which we obtained subsequent to Converge s announcement that it would restructure its business. For the year ended December 31, 2002, we recorded impairment charges on our Converge investment of approximately $9.6 million.

Primarily as a result of losses incurred in 2001 and 2000, we have an accumulated deficit of approximately $1.2 billion as of December 31, 2002. The table below summarizes the income (loss) from continuing operations attributable to common shareholders (including preferred dividends) and the income (loss) attributable to common shareholders, which includes discontinued operations, during the specified periods:

Period	Income (loss) from continuing operations attributable to common shareholders	Income (loss) attributable to common shareholders
	(in millions)	
Year ended December 31, 2002	$ 66.3	$ 74.7
Year ended December 31, 2001	(677.6)	(768.3)
Year ended December 31, 2000	(151.1)	(316.6)

Sale of Verticalnet Exchanges (NECX)

In January 2001, we completed the sale of our Verticalnet Exchanges segment to Converge. Verticalnet Exchanges was comprised of NECX.com LLC, a business we purchased in December 1999, and its subsequent acquisitions of R.W. Electronics, Inc. (RWE) and F&G Capital, Inc. d/b/a American IC Exchange (AICE). In consideration for the sale of Verticalnet Exchanges to Converge, we received 10,371,319 shares of Series B convertible preferred stock and 1,094,751 shares of non-voting common stock, representing approximately 18.0% and 1.9%, respectively, of Converge s equity at the closing of the transaction. The final net worth and working capital adjustment calculation performed in the second quarter of 2001, following a post-closing audit, resulted in us making an aggregate payment of $12.8 million to Converge.

We used the fair value of Verticalnet Exchanges of $215.0 million, as determined by an independent appraisal, to record our investment in Converge. The investment in Converge was accounted for under the cost method of accounting for investments (see Notes 5 and 9 to our consolidated financial statements).

The sale of Verticalnet Exchanges represented the disposal of a business segment under Accounting Principles Board (APB) Opinion No. 30, Reporting the Results of Operations -- Reporting the Effects of Disposal of a

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Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions. Accordingly, results of this segment have been shown as a discontinued operation in all periods presented.

Converge

In December 2000, we entered into a subscription license agreement and professional services agreement with Converge, which among other things, provided for us to receive an aggregate of $108.0 million during the three-year term of the agreements. On October 9, 2001, Verticalnet and Converge terminated the professional services agreement, amended and restated the subscription license agreement and entered into a maintenance and support agreement. The amended and restated subscription license agreement as well as the maintenance and support agreement had a term of 18 months ending in March 2003.

Verticalnet and Converge entered into a first amendment to the amended and restated subscription license agreement and a first amendment to the maintenance and support agreement, both as of February 1, 2002. As a result of these amendments, the term of each agreement was extended to December 31, 2003. The amendment to the maintenance agreement reduced our required level of service, accelerated the payment terms and reduced their aggregate obligation by $0.5 million. The expected contractual payments under the new agreements plus the remaining deferred revenue under the original agreements were anticipated to be recognized on a straight-line basis through December 2003.

In February 2002, we invested $3.5 million in Converge LLC, an indirect subsidiary of Converge, and received a subordinated promissory note with a face value of $8.75 million. The note was payable in four equal installments on February 15th of 2006 through 2009. Repayment of the note was to be accelerated upon certain triggering events, including a change of control. In connection with the investment, we also received a warrant to purchase 3,500,000 shares of preferred stock in Converge Financial Corporation, a wholly-owned subsidiary of Converge and an indirect parent of Converge LLC, at an initial exercise price of $.01 per share. As noted above, we sold all of the Company s equity interest in, and notes receivable from, Converge for cash consideration of approximately $1.9 million on September 30, 2002.

In August 2002, Converge notified the Company that they would not be paying the remaining maintenance amounts through December 2003 according to the first amendment to the maintenance and support agreement. Converge proposed an amended payment schedule that extended the payment terms through October 2006 for the remaining $1.8 million due. This amended payment schedule has not been finalized. Due to the risk of non-collection of all or a portion of the remaining amounts due, the Company began recognizing maintenance revenue from the Converge contract on a cash basis beginning in the fourth quarter of 2002. The remaining amounts due from Converge ($1.7 million) have been fully reserved for as of December 31, 2002. These amounts will be recognized as revenues in 2003 and beyond if and when they are collected.

In November 2002, the Company entered into a second amendment to the amended and restated subscription license agreement with Converge. This amendment eliminated the obligation of the Company to provide future Verticalnet products to Converge at no cost for the term of the original subscription license agreement. As there remained no further obligation by Verticalnet under the license agreement with Converge, the remaining deferred license revenue balance of $19.6 million was recognized during the fourth quarter of 2002. Since all amounts due under the amended and restated subscription license agreement had been collected, the revenue recognized did not represent additional cash inflows to the Company. This amendment did not alter the maintenance and support agreement between the Company and Converge.

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Below are the contractual payments, including revisions, either made or still expected from Converge under the revised terms of the agreements (in thousands):

2002:	Remaining contractual payments as of December 31, 2001	Adjustments due to February 2002 contractual changes	Cash received during the year ended December 31, 2002	Remaining contractual payments as of December 31, 2002 (a)
Subscription license	$ 9,000	$	$ (9,000)	$
Maintenance and support	3,750	(500)	(1,592)	1,658
	$ 12,750	$ (500)	$ (10,592)	$ 1,658

2001:	Contractual payments under original agreements	Adjustments due to October 2001 contractual changes	Cash received during the year ended December 31, 2001	Remaining contractual payments as of December 31, 2001
Subscription license	$ 73,000	$ (23,000)	$ (41,000)	$ 9,000
Professional services	35,000	(23,750)	(11,250)	
Maintenance and support		4,500	(750)	3,750
	$ 108,000	$ (42,250)	$ (53,000)	$ 12,750

(a) The Company has fully reserved for this receivable due to the inherent risk and uncertainty related to its collection.

During the years ended December 31, 2002 and 2001, we recognized revenues of approximately $33.8 million and $29.8 million, respectively, under the Converge agreements. Deferred revenue related to the Converge agreements was approximately $23.2 million at December 31, 2001.

Critical Accounting Policies and Estimates

Accounting policies, methods and estimates are an integral part of the consolidated financial statements prepared by management and are based upon management s current judgments. Those judgments are normally based on knowledge and experience with regard to past and current events and assumptions about future events. Certain accounting policies, methods and estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ from management s current judgments. While there are a number of accounting policies, methods and estimates affecting our financial statements as described in Note 1 to our consolidated financial statements, areas that are particularly significant include revenue recognition policies, the assessment of recoverability of long-lived assets, specifically goodwill and other intangible assets, the valuation of non-publicly traded investments and estimates made in calculating restructuring reserves for operating leases related to facilities that we no longer utilize.

Revenue Recognition

Through December 31, 2002, our software licensing and related services revenues have been principally derived from one customer, Converge. The original arrangement with Converge entailed a right to use our existing software as well as any future software that we developed, the provision of professional services, and maintenance and support services over the life of the agreement. Due to the type of professional services that we were providing to Converge, as well as the fact that Converge was entitled to use, free of charge, any of our future software products, revenue related to Converge was being recognized on a straight-line basis over the term of the arrangements. However, as of

November 5, 2002, the amended and restated subscription license agreement has been amended to relieve the Company of any obligation to provide future software products. As such, the remaining deferred license fees related to the subscription agreement were recognized during the fourth quarter of 2002.

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Software licensing and related services revenues other than from Converge have been principally derived from the licensing of our products, from maintenance and support contracts and from the delivery of professional services. Customers who license our products also generally purchase maintenance contracts which provide software updates and technical support over a stated term, which is usually a twelve-month period. Customers may also purchase implementation services from us.

The license agreements for our products do not provide for a right of return other than during the warranty period, and historically product returns have not been significant. We do not recognize revenue for refundable fees or agreements with cancellation rights until such rights to refund or cancellation have expired. Our products are either acquired under a perpetual license model or under a time-based license model.

We recognize revenue in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions. We recognize revenue when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery of the product has occurred; the fee is fixed or determinable; and collectibility is probable. We consider all arrangements with payment terms extending beyond one year to not be fixed or determinable, and revenue under these agreements is recognized as payments become due from the customer. If collectibility is not considered probable, revenue is recognized when the fee is collected.

SOP 97-2, as amended, generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of the elements. Our determination of fair value of each element in multi-element arrangements is based on vendor-specific objective evidence (VSOE). We limit our assessment of VSOE for each element to either the price charged when the same element is sold separately or the price established by management, having the relevant authority to do so, for an element not yet sold separately.

If evidence of fair value of all undelivered elements exists but evidence does not exist for one or more delivered elements, then revenue is recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. Revenue allocated to maintenance and support is recognized ratably over the maintenance term and revenue allocated to training and other service elements is recognized as the services are performed. The proportion of revenue recognized upon delivery may vary from quarter to quarter depending upon the relative mix of licensing arrangements and the availability of VSOE of fair value for all of the undelivered elements.

Arrangements that include professional services are evaluated to determine whether those services are essential to the functionality of other elements of the arrangement. When services are not considered essential, the revenue allocable to the professional services is recognized as the services are performed. If we provide professional services that are considered essential to the functionality of the software products, both the software product revenue and professional service revenue are recognized in accordance with the provisions of SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. To date, most of our professional services have been considered essential to the functionality and therefore, the majority of our contracts that involved licenses and professional services were recognized on a percentage of completion basis.

Deferred revenue includes amounts received from customers for which revenue has not been recognized, which in most cases relates to maintenance or license fees that are deferred until they can be recognized.

Recoverability of Goodwill, Other Intangible Assets and Investments

As discussed in Note 1 to our consolidated financial statements, we regularly perform reviews to determine whether events or circumstances indicate that the carrying value of long-lived assets, including goodwill and other intangible assets, may not be recoverable. Factors we consider important which could trigger an impairment review include, but are not limited to, significant underperformance relative to historical or projected future operating results, significant changes in the manner of use of the acquired assets or the strategy for our overall business, significant negative industry or economic trends, a significant decline in our stock price for a sustained period, and our market capitalization relative to net book value. When we determine that an impairment review is necessary for

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intangible assets based upon the existence of one or more of the above indicators of impairment, we perform an undiscounted cash flow analysis to evaluate whether future cash flows from the long-lived asset is below its current carrying value. If the result from this analysis indicates that an impairment charge is required for, we measure the impairment based on a projected discounted cash flow method using a discount rate commensurate with the risk inherent in our current business model. Significant judgment is required in the development of projected cash flows for these purposes, including assumptions regarding the appropriate level of aggregation of cash flows, the discount rate to be used as well as the underlying forecasts of expected future revenue and expense.

When we determine that an impairment review is necessary for goodwill, we compare the fair value of the Company to its carrying value. If the result from this analysis indicates that an impairment charge is required, the fair value of the Company is allocated to its identifiable tangible and intangible assets, resulting in an implied valuation of goodwill associated with the Company. We would measure the impairment based on the difference between the implied valuation of the goodwill and its actual carrying value.

We have recorded significant impairment charges for goodwill and intangible assets in the past and to the extent that events or circumstances cause our assumptions to change, additional charges may be required in future periods and such charges could be material. We have also recorded significant impairment charges for non-publicly traded investments which we review quarterly for potential impairment.

Restructuring Reserves for Operating Leases

As discussed in Note 6 to our consolidated financial statements, we have recorded restructuring charges in connection with certain facilities which are leased under long-term operating leases. These charges relate to facilities and portions of facilities we no longer utilize and either seek to terminate early or sublease. Lease termination costs for the facilities were estimated for the remaining lease obligations based on current negotiations with each respective landlord and brokerage fees offset by estimated sublease income. Estimates related to sublease costs and income are based on assumptions regarding the period required to locate and contract with suitable sub-lessees and sublease rates which can be achieved using market trend information analyses provided by a commercial real estate brokerage retained by us. Each reporting period we review these estimates and to the extent that these assumptions change due to continued negotiations with landlords or changes in the market, the ultimate restructuring expenses for these facilities could vary by material amounts.

Results of Continuing Operations

The following discussion and comparison regarding results of continuing operations do not include the results of the SMB unit or the Verticalnet Exchanges unit. The discussion also follows the new presentation of the consolidated statements of operations:

Revenues.

Revenues in the ongoing business are comprised of software license revenues and services and maintenance revenues. For the years ended December 31, 2002, 2001 and 2000, software license revenues were $36.0 million, $25.7 million and $2.2 million, respectively, and service and maintenance revenues were $7.7 million, $10.4 million and $5.7 million, respectively. The increase in software license revenues in 2002 is primarily due to the completion of Verticalnet s collaborative transformation to a supply chain solutions supplier and restructuring of the Converge license agreement. The Company, however, has not executed a software license agreement since March 2002. The significant decline in services and maintenance revenues between 2002 and 2001 is due primarily to the restructured Converge agreement, partially offset by service revenues generated principally from new customers acquired during the first quarter of 2002. The increase in software license revenues of $23.5 million, from $2.2 million for the year ended December 31, 2000 to $25.7 million for the year ended December 31, 2001 and the increase in service and maintenance revenues of $4.7 million, from $5.7 million for the year ended December 31, 2000 to $10.4 million for the corresponding period in 2001, is primarily due to the Converge contract (see Note 10 to our consolidated financial statements).

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Cost of Revenues

The cost of revenues is comprised of the cost of software license and the cost of services and maintenance. The cost of software license is comprised primarily of royalties and the non-cash amortization of currently used technologies acquired through acquisitions. The cost of software license decreased approximately $3.2 million, from $4.2 million for the year ended December 31, 2001 to $0.9 million for the year ended December 31, 2002, due primarily to the decrease in the amortization of the technology acquired in the Isadra and Tradeum acquisitions, partially offset by the cost of acquired technology in relation to the Atlas Commerce acquisition. From 2000 to 2001, the cost of software increased approximately $1.0 million, from $3.1 million for the year ended December 31, 2000 to $4.2 million for the year ended December 31, 2001, due to increased licensing costs from third-party software companies used in our software products.

The cost of services and maintenance includes the cost of the Company s consultants who are primarily responsible for the software implementations and configurations. Also included is the cost of the Company s customer support function, which is provided to customers as part of the recurring maintenance fees. The cost of services and maintenance decreased approximately $16.0 million, from $21.6 million for the year ended December 31, 2001 to $5.6 million for the year ended December 31, 2002, due to reduced third-party consulting cost and a significant reduction in headcount as a result of the restructuring actions taken during the latter part of 2001 and 2002. Also related to the headcount reductions, travel and entertainment expense declined approximately $0.1 million for the year ended December 31, 2002 as compared to the same period in 2001. From 2000 to 2001, the cost of service and maintenance increased approximately $14.9 million, from $6.7 million for the year ended December 31, 2000 to $21.6 million for the year ended December 31, 2001, due to the implementation of the software under the Converge contract (see Note 10 to our consolidated financial statements).

Research and Development

Research and development cost consists primarily of salaries and fringe benefits cost of the Company s product strategy, development, and testing employees. Research and development cost decreased approximately $14.8 million, from $23.8 million for the year ended December 31, 2001 to $9.0 million for the year ended December 31, 2002, primarily due to headcount reductions associated with the restructuring actions taken during the latter part of 2001 and 2002. Salary and fringe related cost accounted for the majority of the decrease. In addition, third-party consulting cost decreased approximately $2.8 million during the year ended December 31, 2002, as compared to the prior period in 2001. Facilities and infrastructure cost attributable to the research and development group contributed approximately $2.3 million to the overall decrease for the year ended December 31, 2002 as compared to the prior period in 2001. Additionally, research and development cost increased approximately $6.6 million, from $17.2 million for the year ended December 31, 2000 to $23.8 million for the year ended December 31, 2001, primarily as a result of the growing number of research and development personnel required to further develop our software products.

Sales and Marketing

Sales and marketing expense consists primarily of salaries and fringe benefits cost, as well as commissions for sales and marketing employees and related travel expenses. Sales and marketing expense for the years ended December 31, 2002, 2001 and 2000 was approximately $5.3 million, $18.1 million and $10.9 million, respectively. The significant decrease in sales and marketing expense for the year ended December 31, 2002 as compared to the prior year is primarily headcount related, as salary and fringe reductions amounted to approximately $5.8 million. In addition, travel related expense declined $1.7 million and direct marketing expense such as advertising, public relations and trade shows declined approximately $1.9 million. The $7.3 million increase in sales and marketing expense, from $10.9 million for the year ended December 31, 2000 to $18.1 million for the year ended December 31, 2001, is due primarily to a larger number of sales and marketing employees and increases in marketing program spending.

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General and Administrative

General and administrative expense consists primarily of salaries and related cost for our executive, administrative, finance, legal and human resources personnel. General and administrative expense was approximately $9.0 million, $24.4 million and $36.2 million for the years ended December 31, 2002, 2001 and 2000, respectively. This expense declined primarily as a result of the headcount cost reductions of approximately $8.1 million between 2001 and 2002. Professional services expense declined approximately $2.0 million between 2001 to 2002, due to a decrease in the Company s use of outside legal and accounting services as a result of the Company s reduced size. General and administrative facilities and infrastructure related reductions accounted for approximately $5.1 million of the decline between 2001 and 2002. In addition, during the year ended December 31, 2002, we settled certain litigation and tax related issues for which accruals had been established. The settlement of these items resulted in a reversal of the remaining accrual and thus reduced general and administrative expense during 2002 by $1.5 million. These are one-time reductions, and are not part of the operating cost structure.

Restructuring and Asset Impairment

Restructuring and asset impairment charges for the years ended December 31, 2002, 2001 and 2000 of $29.1 million, $268.6 million and $6.4 million, respectively, include goodwill impairment charges related to the goodwill recorded in the acquisitions of Atlas Commerce, Tradeum and Isadra. The remaining restructuring charges are comprised primarily of facility leases and severance obligations of approximately $1.6 million, $25.8 million and $0 for the years ended December 31, 2002, 2001 and 2000, respectively. The lease adjustments are indicative of the difficult sublet market that exists for office space in certain markets where the Company currently leases office space. We are actively pursuing settlements of lease obligations for the excess office space. As of January 31, 2003, subsequent to the restructuring of several operating lease agreements which required a payment of $2.3 million , we have $2.3 million in remaining lease obligations on facilities that we no longer utilize.

Amortization Expense

Amortization expense for the years ended December 31, 2002, 2001 and 2000 was approximately $2.1 million, $108.9 million and $126.1 million, respectively, and primarily reflects the amortization of goodwill from purchase business combinations prior to the adoption of SFAS No 142. It also includes the non-cash amortization of deferred costs related to the warrants and Series A convertible redeemable preferred stock issued to Microsoft. Pursuant to the Company s adoption of SFAS No. 142, Goodwill and Other Intangible Assets, the Company discontinued its amortization of goodwill beginning January 1, 2002.

Interest and Other Income (Expense)

Interest and other income (expense), net was comprised of the following (in thousands):

	Year Ended December 31,		
	2002	**2001**	**2000**
Transactions gain	$ 939	$ 910	$
Write off of obsolete software	(711)	(2,819)	(4,122)
Equity investment loss		(2,312)	
Inducement charge	(2,869)		
Interest income (expense)	(2,597)	37	
Gain (loss) on early extinguishment of debt	4,804		(11,207)
Realized gain (loss) on investments		(3,829)	79,875
Impairment charges investments	(11,564)	(231,327)	
In-process research and development charge		(420)	(10,000)
Other income (expense) items including terminated deal costs	(1,480)	3,029	(1,661)
	$ (13,478)	$ (236,731)	$ 52,885

Interest and other income (expense), net			

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In June 2002, the Company repurchased all of its outstanding Series A 6% convertible redeemable preferred stock. At the time of the repurchase, the carrying value of the preferred stock and the related accumulated dividends was approximately $106.0 million. The Company paid $5.0 million in cash consideration for the preferred shares, resulting in an increase in paid in capital of $101.0 million which is included in income attributable to common shareholders.

Liquidity and Capital Resources

As of December 31, 2002, our primary source of liquidity consists of cash and short-term investments. The majority of such funds are readily available for operating purposes. At December 31, 2002, we had cash and cash equivalents totaling approximately $8.0 million and working capital of $3.9 million. As of February 28, 2003, we had cash, cash equivalents and highly liquid investments of $4.9 million and working capital of $4.5 million.

Net cash used in operating activities was $26.5 million for the year ended December 31, 2002 compared to $71.3 million for the year ended December 31, 2001. The reduction in the net cash used in operating activities is primarily a function of a smaller loss incurred from continuing operations.

In 2002, $1.8 million of net cash was provided by investing activities, compared to net cash used in investing activities of $15.2 million in 2001. Cash provided by investing activities for the year ended December 31, 2002 includes $2.4 million from the sale of the SMB unit, $1.85 million from the sale of our investment in Converge and $2.0 million from the release of previously restricted funds. Cash used in investing activities included the Company s additional investment of $3.5 million in Converge and proceeds of $2.3 million from the sale of cost and equity method investments. Capital expenditures and capitalized software costs for the year ended December 31, 2002 were approximately $0.8 million, which consists primarily of capitalized software costs related to the development of the Verticalnet products.

Net cash used in financing activities was approximately $17.8 million in 2002, compared to net cash provided by financing activities of $13.6 million in 2001. The 2002 amount includes $8.4 million for the settlement of the principal portion of the BT put and call obligation (the settlement included an additional payment of $1.1 million for accrued interest which is reflected in cash used in operating activities in the statement of cash flows) and $5.0 million for the repurchase of all of the Company s outstanding convertible redeemable preferred stock. In addition, during 2002 we completed the repurchase of $14.6 million of our 5 1/4% convertible subordinated debentures due September 2004 for total cash consideration of $2.5 million. The remaining $7.1 million of debentures continue to accrue interest and obligate the Company to make semi-annual interest payments accordingly. Also included in net cash used in financing activities was approximately $1.0 million paid under the put agreement with Atlas Commerce shareholders, as well as $1.3 million of principal payments on capital leases.

As of December 31, 2002, we have $3.5 million of accrued restructuring costs primarily related to facility leases, $0.1 million of which were assumed as part of the Atlas Commerce acquisition. We have made significant efforts to estimate the expected costs to early terminate the leases or sublease facilities. If these facilities cannot be sublet or the leases early terminated, our contractual lease payments of approximately $3.5 million related to these leases will be due over the respective lease terms in addition to aggregate contractual lease payments of less then $0.1 million related to facilities we continue to use.

We believe that our current level of liquid assets and the expected cash flows from contractual arrangements will be sufficient to finance our capital requirements and anticipated operating losses through at least March 31, 2004. However, to the extent that the current level of liquid assets or future revenues prove to be insufficient, we may need to further reduce our operating costs or obtain additional debt or equity financing. Additionally, we may, if the capital markets present attractive opportunities, raise cash through the sale of debt or equity. We can provide no assurance that we will be successful in obtaining any required or desired financing either on acceptable terms or at all.

In November 2002, we announced that we had retained US Bancorp Piper Jaffray, an investment banker, to pursue a potential sale of the Company. In the event that we complete a sale, certain severance and third-party obligations could be triggered, which could be substantial. If it would enhance our ability to sell all or part of the Company or provide economic benefits, we may attempt to settle outstanding non-cancelable lease obligations and/or the Company s convertible notes. If successful, our financial resources will be reduced.

Contractual Commitments

The following table outlines future contractual commitments reflecting the effects of our restructured lease agreement (see Note 12 to our consolidated financial statements).

Expected Cash Payment by Year
(in thousands)

	2003	2004	2005	2006	2007 and beyond	Total
Convertible notes	$	$ 7,135	$	$	$	$ 7,135
Operating leases	3,364	741	190	34		4,329
Capital leases	415	151	7			573(a)
Total	$ 3,779	$ 8,027	$ 197	$ 34	$	$ 12,037

(a) Capital lease balances excludes future interest obligations.

Recent Accounting Pronouncements

In June 2001, the FASB issued SFAS No. 141, Business Combinations, and SFAS No. 142. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated or completed after June 30, 2001. SFAS No. 141 also specifies criteria that must be met for intangible assets acquired in a purchase method business combination to be recognized and reported separately from goodwill, noting that any purchase price allocable to an assembled workforce may not be accounted for separately. SFAS No. 142, which became effective January 1, 2002, requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually in accordance with the provisions of SFAS No. 142. SFAS No. 142 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Accordingly, there has been no amortization of goodwill since December 31, 2001 (see Note 8 to our consolidated financial statements for additional discussion).

In August 2001, the FASB issued SFAS No. 144, which supersedes both SFAS No. 121, Accounting for the Impairment of Long-Lived Assets to be Disposed Of, and the accounting and reporting provisions of APB Opinion No. 30, Reporting the Results of Operations -- Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, for the disposal of a segment of a business. SFAS No. 144 retains the fundamental provisions of SFAS No. 121 for recognizing and measuring impairment losses on long-lived assets held for use and long-lived assets to be disposed of by sale, while also resolving significant implementation issues associated with SFAS No. 121. For example, SFAS No. 144 provides guidance on how a long-lived asset that is used as part of a group should be evaluated for impairment, establishes criteria for when a long-lived asset is held for sale, and prescribes the accounting for a long-lived asset that will be disposed of other than by sale. SFAS No. 144 retains the basic provisions of APB Opinion No. 30 on how to present discontinued operations in the income statement but broadens that presentation to include a component of an entity (rather than a segment of a business). We adopted and implemented SFAS No. 144 as of January 1, 2002. The adoption of SFAS No. 144 did not have a significant impact on our results of operations, financial position or cash flows.

In November 2001, the FASB issued Topic D-103, Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred, subsequently recharacterized as Emerging Issues Task Force

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(EITF) Issue No. 01-14. EITF Issue No. 01-14 states that reimbursements received for out-of-pocket expenses incurred should be characterized as revenue in the income statement. This guidance was to be applied in financial reporting periods beginning after December 15, 2001 and comparative financial statements for prior periods were to be reclassified to comply with the guidance. Accordingly, the consolidated financial statements of operations have been reclassified pursuant to this guidance.

In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections. SFAS No. 4, Reporting Gains and Losses from Extinguishment of Debt, required that gains and losses from extinguishments of debt be included in the determination of net income and be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. SFAS No. 145 is effective beginning January 1, 2003, however, the Company has elected to early adopt the provisions of SFAS No. 145. During the third quarter of 2002, in connection with the settlement of obligations involving British Telecommunications Plc. (BT), the Company recognized a $4.8 million gain representing the difference between the fair value of the consideration issued in the settlement transaction and the carrying value of the amounts due BT. As a result of the early adoption of SFAS No. 145, the Company evaluated the classification of this gain in accordance with the provisions of APB Opinion No. 30 and determined that the gain does not meet the criteria for classification as an extraordinary item. As a result, the gain has been included in interest and other income (expense), net within income from continuing operations in the accompanying consolidated statements of operations for the year ended December 31, 2002 (see Note 18 to our consolidated financial statements).

In June 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. This Statement addresses the financial accounting and reporting of expenses related to restructurings initiated after 2002, and applies to costs associated with an exit activity (including a restructuring) or with a disposal of long-lived assets. Those activities can include eliminating or reducing product lines, terminating employees and contracts, and relocating plan facilities or personnel. Under SFAS No. 146, a company will record a liability for a cost associated with an exit or disposal activity when the liability is incurred and can be measured at fair value. The provisions of SFAS No. 146 are effective prospectively for exit or disposal activities initiated after December 31, 2002.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, which amends SFAS No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements. Certain of the disclosure modifications are required for fiscal years ending after December 15, 2002, which the Company has applied in these consolidated financial statements. The adoption of SFAS No. 148 is not expected to have a significant impact on our results of operations, financial position or cash flows because the Company does not expect to adopt the fair value method of accounting.

FACTORS AFFECTING OUR BUSINESS CONDITION

We may require additional capital for our operations and obligations, and, as a result, we are exploring alternatives to preserve value, including the sale of the company.

Although, based on our most recent projections, we believe our current level of liquid assets and the expected cash flows from contractual arrangements will be sufficient to finance our capital requirements and anticipated for the next twelve months, any projection of future long-term cash needs and cash flows are inherently subject to uncertainty. There is no assurance that our resources will be sufficient for anticipated or unanticipated working capital and capital expenditure requirements during this period. We may need, or find it advantageous, to raise additional funds in the future to fund our growth, pursue sales and licensing opportunities, develop new or enhanced products and services, respond to competitive pressures or acquire complementary businesses, technologies or services.

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If we are ultimately unable, for any reason, to receive cash payments expected from our customers, our business, financial condition and results of operations will be materially and adversely affected.

We may not generate an operating profit.

As of December 31, 2002, our accumulated deficit was approximately $1.2 billion. Although we generated a profit in the fourth quarter of 2002, we expect to incur operating losses for the foreseeable future. We may never generate an operating profit or, even if we do become profitable from operations at some point, we may be unable to sustain that profitability.

We may not develop significant revenues from enterprise software licensing and professional services, which could adversely affect our future revenue growth and ability to achieve profitability.

If we do not develop and consistently generate significant revenues from enterprise software licensing and professional services, our business, financial condition and operating results will be impaired. Our ability to generate software revenues depends on the overall demand for enterprise software solutions and professional services, as well as general economic and business conditions. Suppressed demand for software solutions and services caused by a weakening economy and reduced levels of spending on technology solutions may result in less revenue growth than expected or even a decline in revenues. We cannot offer any assurances that we will be able to develop, enhance or promote our enterprise software solutions and professional services effectively, whether as a result of general economic conditions or otherwise.

We anticipate lengthy sales cycles for our software products, and difficulty in obtaining customer commitments.

The Company has not executed a software license agreement since March 2002. Looking forward, we anticipate the sales cycles for our enterprise software products to average approximately three to six months. We have experienced an increase in the length of sales cycles during 2002. We have also experienced difficulty in obtaining customer commitments to enter into contracts even after we have been selected as the preferred vendor. If the economy and the market for technology solutions remain depressed or continue to worsen, then our average sales cycle could become increasingly longer and our ability to enter into customer agreements could be come increasingly more difficult. In selling our products, we may be asking potential customers in many cases to change their established business practices and conduct business in new ways. In addition, potential customers must generally consider additional issues, such as product benefits, ease of installation, ability to work with existing technology, functionality and reliability, and adoption by their suppliers, before committing to purchase our products. Additionally, we believe that the purchase of our products is often discretionary and generally involves a significant commitment of capital and other resources by a customer, which frequently requires approval at a number of management levels within the customer organization. Likewise, the implementation and deployment of our enterprise software products requires a significant commitment of resources by our customers and our professional services organization. The challenges we face in attempting to obtain commitments and approvals from our customers may be exacerbated by worsening economic conditions in general and in our target markets, as well as by competition from other software solution providers whose brands, products and services may be better known to, and more widely accepted by, potential customers than ours.

We may be unable to maintain our listing on the Nasdaq stock market, which could cause our stock price to fall and decrease the liquidity of our common stock.

Our common stock is currently listed on The Nasdaq Stock Market, which has requirements for the continued listing of stock. In May 2002, we transferred our listing from the Nasdaq National Market to the Nasdaq Small-Cap Market due to our inability to comply with the Nasdaq National Market bid price and shareholders equity requirements. Continued listing on the Nasdaq Small-Cap Market requires us to maintain $2.5 million in shareholders equity and our common stock to maintain a minimum bid price of $1.00 per share. Although we completed a one-for-ten reverse split of our common stock on July 15, 2002, the bid price for our common stock has closed below $1.00 for several weeks at a time. We will not meet the continued listing standard if the closing price of our common stock is less than $1.00 for 30 consecutive trading days. As of December 31, 2002, shareholders equity

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is approximately $1.6 million, which is below the Nasdaq Small-Cap Market continued listing requirement. On March 6, 2003, the Nasdaq notified us that we are not in compliance with the minimum bid price rule. We have 180 days, or until September 2, 2003, to regain compliance with the minimum bid price rule or delisting procedures will occur. However, because we have not maintained $2.5 million in shareholders equity, delisting procedures may begin earlier than September 2, 2003.

If our stock is delisted from the Nasdaq stock market and our share price declines significantly, then our stock may be deemed to be penny stock.

If our common stock is considered penny stock, it would be subject to rules that impose additional sales practices on broker-dealers who sell our securities. Because of these additional obligations, some brokers may be unwilling to effect transactions in our stock. This could have an adverse effect on the liquidity of our common stock and the ability of investors to sell the common stock. For example, broker-dealers must make a special suitability determination for the purchaser and have received the purchaser s written consent to the transaction prior to sale. Also, a disclosure schedule must be prepared prior to any transaction involving a penny stock and disclosure is required about sales commissions payable to both the broker-dealer and the registered representative and current quotations for the securities. Monthly statements are required to be sent disclosing recent price information for the penny stock held in the account and information on the limited market in penny stock.

If our stock is delisted from the Nasdaq stock market and our share price declines significantly, then we may be unable to license our products and sell our services to prospective or existing customers.

If our stock is delisted and our share price declines significantly, our prospective and existing customers may lose confidence that we can continue as a viable business to provide the support necessary to further develop the solution and provide ongoing maintenance and consulting services. Prospective and existing customers could consider alternative solutions or significantly reduce the value they are willing to pay for our solution to compensate for the potential added risk to their business. Our ability to meet our revenue goals could be adversely impacted, resulting in further deterioration of the financial condition of the business.

Our ability to complete the reorganization of the Company depends on our key management and experienced software personnel, whom we may not be able to retain.

We believe that our ability to complete a successful reorganization of the Company depends on continued employment of our senior management team and on maintaining a highly trained product development staff. If one or more members of our senior management team were unable or unwilling to continue in their present positions, our prospects for reorganizing the Company could be materially adversely affected. If we are unable to retain trained technical personnel, it could limit our ability to design and develop products, which could reduce our attractiveness to potential investors or acquirers.

We may not be able to hire enough additional personnel to meet our hiring needs.

Our success also depends on having a highly trained professional services and development personnel. We may need to hire additional personnel if our business grows. A shortage in the number of trained consultants and developers could limit our ability to implement our software if we are able to license software to new customers or if our present customers ask us to perform more services for them. Competition for personnel, particularly for employees with technical expertise, could be strong. Our business, financial condition and operating results will be materially adversely affected if we cannot hire and retain suitable personnel.

We may have to amend previously filed reports with respect to revenue and expense items of our discontinued SMB business if we cannot otherwise resolve comments we have received from the SEC.

In connection with our acquisition of Atlas Commerce, we filed a registration statement on Form S-3 with the SEC registering the resale of shares of our common stock issued in the acquisition. In connection with a routine review and comment letter process related to this filing, we have received comments from the SEC. The remaining

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open comments relate primarily to the presentation and recognition of certain previously reported revenue and expense items of our SMB business and whether one element of a material agreement should be accounted for as barter in accordance with EITF Issue No. 99-17, Accounting for Advertising Barter Transactions. We believe the ultimate resolution of such comments would not change our accumulated deficit at December 31, 2002, although there could be differences in reported quarterly operating results (refer to Note 12 to the consolidated financial statements for additional information). The remaining open SEC comments do not relate in any way to our ongoing collaborative supply chain software operations. The SMB business was sold on June 28, 2002, and that business unit is reflected in our financial statements as a discontinued operation for all periods presented, which requires that all elements of revenue and expense be netted as a single line item to report net results of discontinued operations. As a result, revenues and expenses of our SMB business are no longer separately presented in our financial statements. We filed a response to the matters raised by the SEC and are awaiting their response. We are currently in the process of resolving these matters with the SEC and believe the historical presentations and recognition of revenue and expense for the SMB business are appropriate. If the SEC will not declare the Form S-3 effective without us first revising the historical presentation and recognition of previously reported revenue and expense items of our SMB business, then we will have to amend the reports that are incorporated into the Form S-3.

Fluctuations in our quarterly operating results may cause our stock price to decline.

Our quarterly operating results are difficult to forecast and could vary significantly. If our operating results in a future quarter or quarters do not meet the expectations of securities analysts or investors, the price of our common stock may fall. Our quarterly operating results will be substantially dependent on software licenses booked and delivered in that quarter. Any delay in the recognition of revenue for any of our license transactions could cause significant variations in our quarterly operating results and could cause our revenues to fall significantly short of anticipated levels. We also expect that our quarterly operating results will fluctuate significantly due to other factors, many of which are beyond our control, including:

- anticipated lengthy sales cycles for our products;
- the size and timing of individual license transactions;
- intense and increased competition in our target markets;
- our ability to develop, introduce and bring to market new products and services, or enhancements to our existing products and services, on a timely basis; and
- risks associated with past acquisitions.

If we are able to grow our business, we may not be able to manage the growth successfully.

If we are able to grow our business, such growth could place a significant strain on our resources and systems. To manage our growth, we must implement systems and train and manage our employees. In addition, we may not be able to limit our exposure to non-creditworthy customers.

We may seek to raise or acquire additional capital, which could dilute our existing shareholders.

We may seek to grow our business by acquiring another business which has additional capital. In addition, we may seek to raise additional capital. We may be required to incur debt or issue equity securities to pay for acquisitions or to acquire additional capital, which may be dilutive to our existing shareholders.

We expect to rely on third parties to implement our products.

We expect to rely on third parties to implement our software products at customer sites. If we are unable to establish and maintain effective, long-term relationships with implementation providers, or if these providers do not meet the needs or expectations of our customers, our business could be seriously harmed. As a result of the limited

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resources and capacities of many third-party implementation providers, we may be unable to establish or maintain relationships with third parties having sufficient resources to provide the necessary implementation services to support our needs. If these resources are unavailable, we will be required to provide these services internally, which could significantly limit our ability to meet our customers implementation needs. A number of our competitors have significantly more well established relationships with third parties that we may potentially partner with. As a result, these third parties may be more likely to recommend competitors products and services rather than our own. In addition, we would not be able to control the level and quality of service provided by our implementation partners.

New versions and releases of our products may contain errors or defects.

Our enterprise software products 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. Errors in new releases and new products after their introduction could result in delays in release, lost revenues and customer frustration during the period required to correct these errors. We may in the future discover errors and defects in new releases or new products after they are shipped or released.

Our target markets are evolving and characterized by rapid technological change, which we may not be able to keep pace with.

The markets for our products and services are evolving and characterized by rapid technological change, changing customer needs, evolving industry standards and frequent new product and service announcements. The introduction of products employing new technologies and emerging industry standards could render our existing products or services obsolete or unmarketable. If we are unable to respond to these developments successfully or do not respond in a cost-effective way, our business, financial condition and operating results will suffer. To be successful, we must continually improve and enhance the responsiveness, services and features of our enterprise software products and introduce and deliver new product and service offerings and new releases of existing products. We may fail to improve or enhance our software products or introduce and deliver new releases or new offerings on a timely and cost-effective basis or at all. If we experience delays in the future with respect to our software products, or if our improvements, enhancements, offerings or releases to these products do not achieve market acceptance, we could experience a delay or loss of revenues and customer dissatisfaction. Our success will also depend in part on our ability to acquire or license third-party technologies that are useful in our business, which we may not be able to do.

We may ultimately be unable to compete in the markets for the products and services we offer.

The markets for our software products and services are intensely competitive, which may result in low or negative profit margins and difficulty in achieving market share, either of which could seriously harm our business. We expect the intensity of competition to increase. Our enterprise software products and services face competition from software companies whose products or services compete with a particular aspect of the solution we provide, as well as several major enterprise software developers. Many of our competitors have longer operating histories, greater brand recognition and greater financial, technical, marketing and other resources than we do, and may have well-established relationships with our existing and prospective customers. This may place us at a disadvantage in responding to our competitors pricing strategies, technological advances, advertising campaigns, strategic partnerships and other initiatives. Our competitors may also develop products or services that are superior to or have greater market acceptance than ours. If we are unable to compete successfully against our competitors, our business, financial condition and operating results would be negatively impacted.

We have had decreases in the fair value, and in some cases a complete loss, of our equity investments.

We hold investments in equity instruments of privately held companies that we made for business and strategic purposes prior to 2002. Such items are included in other investments on our balance sheet. For the year ended December 31, 2002, we recorded an aggregate of $12.0 million in impairment charges for other than temporary declines in the fair value of our cost method, equity method and available-for-sale investments, $9.6 million of which was a write-down of the fair value of our equity investment in, and note receivable from, Converge, for which we

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entered into a sale agreement as of September 30, 2002. As of December 31, 2002, we held cost method investments with a carrying value of $0.6 million. We may never realize any return on our equity interests that we continue to hold, and we may suffer a complete loss of these interests, which could materially and adversely affect our business, financial condition and operating results.

If we do not develop the Verticalnet brand in the enterprise software industry, our revenues might not increase.

We must establish and continuously strengthen the awareness of the Verticalnet brand in the enterprise software industry. If our brand awareness as a maker of enterprise software does not develop, or if developed, is not sustained as a respected brand, it could decrease the attractiveness of our products and services to potential customers, which could result in decreased revenues.

Our interests may conflict with those of Internet Capital Group, our largest shareholder, which may affect our business strategy and operations negatively.

As a result of its stock ownership and board representation, Internet Capital Group is in a position to affect our business strategy and operations, including corporate actions such as mergers or takeover attempts, in a manner that could conflict with the interests of our public shareholders. At December 31, 2002, Internet Capital Group beneficially owned 3,579,172 shares, or approximately 26%, of our common stock, which includes 62,703 shares of our common stock underlying warrants issued to Internet Capital Group prior to our initial public offering. One representative of Internet Capital Group is a member of our board of directors and a second member of the board of directors is an employee of Internet Capital Group. We may compete with Internet Capital Group and its partner companies for enterprise software opportunities, in part through acquisitions and investments. Internet Capital Group, therefore, may seek to acquire or invest in companies that we would find attractive. While we may partner with Internet Capital Group on future acquisitions or investments, we have no current contractual obligations to do so. We do not have any contracts or other understandings that would govern resolution of this potential conflict. This competition, and the potential conflict posed by the designated director, may deter companies from partnering with us and may limit our business opportunities.

Internet Capital Group may have to buy or sell our stock to avoid registration under the Investment Company Act of 1940, which may negatively affect our stock price.

To avoid registration under the Investment Company Act of 1940, Internet Capital Group may need to continue to own more than 25% of our voting securities and to continue to have a representative on our board of directors. Under the Investment Company Act, a company is considered to control another company if it owns more than 25% of that company s voting securities and is the largest stockholder of such company. A company may be required to register as an investment company if more than 45% of its total assets consist of, and more than 45% of its income/loss and revenue attributable to it over the last four quarters is derived from, ownership interests in companies it does not control. Internet Capital Group has publicly stated that it is not feasible to be regulated as an investment company because the Investment Company Act rules are inconsistent with their corporate strategy. As of December 31, 2002, Internet Capital Group s ownership interest in us was 18%. Internet Capital Group s total beneficial ownership in us is 3,579,172 or 26% of our common stock, because it has an agreement with Safeguard Scientifics that provides it with the right of first refusal to purchase the 1,052,308 shares of our stock that Safeguard owns. If its ownership interest falls below 25%, Internet Capital Group may need to purchase additional voting securities to return to an ownership interest of at least 25% to avoid having to register as an investment company. The possible need of Internet Capital Group to maintain a 25% ownership position could adversely influence its decisions regarding actions that may otherwise be in the best interests of our public shareholders. If Internet Capital Group sells all or part of its investment in us, whether to comply with the Investment Company Act of 1940, to raise additional capital or otherwise, it could adversely affect our common stock s market price.

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We may not be able to protect our proprietary rights and may infringe the proprietary rights of others.

Proprietary rights are important to our success and our competitive position. We may be unable to register, maintain and protect our proprietary rights adequately or to prevent others from claiming violations of their proprietary rights. Although we file copyright registrations for the source code underlying our software, enforcement of our rights might be too difficult and costly for us to pursue effectively. We have filed patent applications for the proprietary technology underlying our software, but our ability to fully protect this technology is contingent upon the ultimate issuance of the corresponding patents. Effective patent, copyright and trade secret protection of our software may be unavailable or limited in certain countries.

Several lawsuits have been brought against us and the outcome of these lawsuits is uncertain.

Several lawsuits have been brought against us and the underwriters of our stock in our initial public offering. These lawsuits allege, among other things, that the underwriters engaged in sales practices that had the effect of inflating our stock price, and that our prospectus for that offering was materially misleading because it did not disclose these sales practices. We intend to vigorously defend against these lawsuits. No assurance can be given as to the outcome of these lawsuits.

Shares eligible for future sale by our current or future shareholders may cause our stock price to decline.

If our shareholders or option holders sell substantial amounts of our common stock in the public market, including shares issued in completed or future acquisitions or upon the exercise of outstanding options and warrants, then the market price of our common stock could fall. As of December 31, 2002, the holders of 3,528,500 shares of common stock and warrants to purchase 62,703 shares of common stock have demand and/or piggyback registration rights. The exercise of such rights could adversely affect the market price of our common stock. We also have filed a shelf registration statement to facilitate our acquisition strategy, as well as registration statements to register shares of common stock under our stock option and employee stock purchase plans. Shares issued pursuant to existing or future shelf registration statements, upon exercise of stock options and in connection with our employee stock purchase plan will be eligible for resale in the public market without restriction.

Anti-takeover provisions and our right to issue preferred stock could make a third-party acquisition of us difficult.

Verticalnet is a Pennsylvania corporation. Anti-takeover provisions of Pennsylvania law could make it more difficult for a third party to acquire control of us, even if such change in control would be beneficial to our shareholders. Our articles of incorporation provide that our board of directors may issue preferred stock without shareholder approval. In addition, our bylaws provide for a classified board, with each board member serving a staggered three-year term. The issuance of preferred stock and the existence of a classified board could make it more difficult for a third party to acquire us.

Our common stock price is likely to remain highly volatile.

The market for stocks of technology companies has been highly volatile since our initial public offering in 1999. Throughout this period, the market price of our common stock has reached extreme highs and lows, and our daily trading volume has been, and will likely continue to be, highly volatile. Investors may not be able to resell their shares of our common stock following periods of price or trading volume volatility because of the market s adverse reaction to such volatility. Factors that could cause volatility in our stock price and trading volume, in some cases regardless of our operating performance, include, among other things:

- general economic conditions, including suppressed demand for technology products and services;
- actual or anticipated variations in quarterly operating results;
- announcements of technological innovations;

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- new products or services;
- changes in the market valuations of other software or technology companies;
- failure to meet analysts or investors expectations;
- announcements by us or our competitors of significant acquisitions, strategic partnerships or joint ventures;
- our cash position and cash commitments;
- our prospects for software sales and new customers; and
- additions or departures of key personnel.

Item 7A. ***Quantitative and Qualitative Disclosure About Market Risk***

Our exposure to market risk related changes in interest rates relates primarily to our investment portfolio. We have invested in instruments that meet high quality credit standards, as specified in our investment policy. The policy also limits the amount of credit exposure we may have to any one issue, issuer or type of investment. As of December 31, 2002, our portfolio of investments included $8.0 million in cash and cash equivalents and $1.0 million that is recorded in prepaid expenses and other assets. Due to the conservative nature of our investment portfolio, we believe that a sudden change in interest rates would not have a material effect on the value of the portfolio. We estimate that if the average yield of our investments had decreased by 100 basis points, our interest income for the year ended December 31, 2002 would have decreased by less than $0.1 million. This estimate assumes that the decrease occurred on the first day of the year and reduced the yield of each investment instrument by 100 basis points. The impact on our future interest income and future changes in investment yields will depend largely on the gross amount of our investment portfolio.

We have invested in equity instruments of privately held companies for business and strategic purposes. These investments are included in other investments and are accounted for under the cost method when ownership is less than 20% and we do not have the ability to exercise significant influence over operations. As of December 31, 2002 we hold cost method equity investments with a carrying value of approximately $0.6million. For these investments in privately held companies, our policy is to regularly review the assumptions underlying the operating performance and cash flow forecasts in assessing the recoverability of the carrying values. We identify and record impairment losses when events and circumstances indicate that such assets might be impaired.

In connection with Ariba s acquisition of Tradex Technologies, Inc., we received Ariba common stock. In July 2000, we entered into forward sale contracts relating to our investment in Ariba. Under these contracts, we pledged our shares of Ariba s common stock to the counter-party for a three-year period in return for approximately $47.4 million of cash. At the conclusion of the three-year period, we have the option of delivering either cash or the pledged Ariba shares to satisfy the forward sale. However, we will not be required to deliver shares in excess of those we pledged. If we choose to deliver Ariba shares to satisfy the forward sale, the number of Ariba shares to be delivered at maturity may vary depending on the then market price of Ariba s common stock. We have only limited involvement with derivative financial instruments and do not use them for trading purposes. Our risk of loss in the event of nonperformance by the counter-party under the forward sales contract is not considered to be significant. Although the forward sales contract exposes us to market risk, fluctuations in the fair value of these contracts are mitigated by expected offsetting fluctuations in the fair value of the pledged securities.

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Item 8. ***Financial Statements and Supplementary Data***

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INDEPENDENT AUDITORS REPORT

To the Board of Directors
and Shareholders of Verticalnet, Inc.:

We have audited the accompanying consolidated balance sheets of Verticalnet, Inc. and subsidiaries as of December 31, 2002 and 2001, and the related consolidated statements of operations, cash flows, shareholders equity (deficit) and other comprehensive loss for each of the years in the three-year period ended December 31, 2002. In connection with our audits of the consolidated financial statements, we also have audited the financial statement schedule as of and for the three years ended December 31, 2002. These consolidated financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Verticalnet, Inc. and subsidiaries as of December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole presents fairly, in all material respects, the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, effective January 1, 2002, the Company adopted the provisions of Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, as required for goodwill and intangible assets resulting from business combinations.

KPMG LLP

Philadelphia, Pennsylvania
January 31, 2003, except
as to Note 20, which is
as of February 6, 2003

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VERTICALNET, INC.
CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS)

	December 31,	
	2002	**2001**
Assets		
Current assets:		
Cash and cash equivalents	$ 7,979	$ 50,252
Accounts receivable, net of allowance for doubtful accounts of $1,684 at December 31, 2002 and $101 at December 31, 2001	1,586	692
Prepaid expenses and other current assets	3,892	5,958
Assets held for disposal		10,319
Total current assets	13,457	67,221
Property and equipment, net	912	6,896
Long-term investments		2,599
Other investments	606	10,831
Goodwill and other intangibles, net of accumulated amortization of $900 at December 31, 2002 and $24,302 at December 31, 2002	1,800	30,410
Other assets	1,678	7,674
Total assets	$ 18,453	$ 125,631
Liabilities and Shareholders Equity (Deficit)		
Current liabilities:		
Current portion of long-term debt	$ 415	$ 1,346
Accounts payable and accrued expenses	7,652	27,270
Deferred revenues	279	24,381
Other current liabilities	1,172	13,603
Liabilities held for disposal		22,279
Total current liabilities	9,518	88,879
Long-term debt and convertible notes	7,293	22,255
Other long-term liabilities		2,599
Total liabilities	16,811	113,733
Commitments and contingencies (see Notes 2, 12 and 13)		
Series A 6.00% convertible redeemable preferred stock, $.01 par value, 250,000 shares authorized, none issued at December 31, 2002 and 109,290 shares issued at December 31, 2001, plus accrued dividends of $1,639 at December 31, 2001		102,180
Put arrangement involving common stock		1,057

Shareholders equity (deficit):		
Preferred stock $.01 par value, 10,000,000 shares authorized, 0 issued at December 31, 2002 and December 31, 2001		
Common stock $.01 par value, 100,000,000 shares authorized, 13,708,546 shares issued at December 31, 2002 and 11,300,621 shares issued at December 31, 2001	137	113
Additional paid-in capital	1,170,742	1,055,351
Deferred compensation	(239)	(98)
Accumulated other comprehensive loss	(736)	(959)
Accumulated deficit	(1,167,457)	(1,144,941)
	2,447	(90,534)
Treasury stock at cost, 65,636 shares at December 31, 2002 and December 31, 2001	(805)	(805)
Total shareholders equity (deficit)	1,642	(91,339)
Total liabilities and shareholders equity (deficit)	$ 18,453	$ 125,631

See accompanying notes to consolidated financial statements.

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VERTICALNET, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Year ended December 31,		
	2002	**2001**	**2000**
Revenues:			
Software license	$ 36,043	$ 25,732	$ 2,204
Services and maintenance	7,681	10,387	5,702
Total revenues	43,724	36,119	7,906
Cost of Revenues:			
Cost of software license	928	4,151	3,127
Cost of services and maintenance	5,602	21,618	6,703
Total cost of revenues	6,530	25,769	9,830
Gross profit (loss)	37,194	10,350	(1,924)
Research and development	8,975	23,757	17,168
Sales and marketing	5,305	18,146	10,856
General and administrative	9,039	24,425	36,221
Restructuring and asset impairment charges	29,144	268,626	6,439
Amortization expense	2,112	108,862	126,071
	54,575	443,816	196,755
Operating loss	(17,381)	(433,466)	(198,679)
Interest and other income (expense), net	(13,478)	(236,731)	52,885
Loss from continuing operations	(30,859)	(670,197)	(145,794)
Discontinued operations:			
Income (loss) from operations of discontinued operations	8,508	(86,752)	(83,554)
Loss on disposal of discontinued operations	(165)	(3,903)	(81,968)
Net loss	(22,516)	(760,852)	(311,316)
Preferred stock dividends and accretion	(3,861)	(7,420)	(5,264)
Repurchase of convertible redeemable preferred stock	101,041		
Income (loss) attributable to common shareholders	$ 74,664	$ (768,272)	$ (316,580)
BASIC INCOME (LOSS) PER COMMON SHARE:			

Income (loss) from continuing operations	$ 5.52	$ (69.92)	$ (18.17)
Income (loss) from discontinued operations	0.71	(8.95)	(10.05)
Loss on disposal of discontinued operations	(0.01)	(0.40)	(9.86)
Income (loss) per common share	$ 6.22	$ (79.27)	$ (38.08)
DILUTED INCOME (LOSS) PER COMMON SHARE:			
Income (loss) from continuing operations	$ (2.56)	$ (69.92)	$ (18.17)
Income (loss) from discontinued operations	0.70	(8.95)	(10.05)
Loss on disposal of discontinued operations	(0.01)	(0.40)	(9.86)
Income (loss) per common share	$ (1.87)	$ (79.27)	$ (38.08)
Weighted average common shares outstanding:			
Basic	12,004	9,692	8,313
Diluted	12,068	9,692	8,313

See accompanying notes to consolidated financial statements.

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

	Year ended December 31,		
	2002	**2001**	**2000**
Cash flows from operating activities			
Net loss	$ (22,516)	$ (760,852)	$ (311,316)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	10,314	135,622	147,286
Non-cash restructuring charges		37,475	
Goodwill and intangible asset impairment	27,595	284,353	11,530
Write-down related to cost method, equity method and available-for-sale investments	11,600	231,327	6,439
Other non-cash charges	1,475	3,107	143
Loss on disposal of property and equipment	2,548	286	
Loss from equity method investments		2,312	2,769
Loss on disposal of discontinued operations	165	3,903	81,968
Realized loss (gain) on investments	(35)	3,829	(79,875)
Gain on debt retirement	(607)		
In-process research and development charge		420	10,000
Gain on BT settlement	(4,804)		
Inducement expense related to repurchase of convertible debt	2,869		
Discontinued operations - working capital changes and noncash charges			109,778
Change in assets and liabilities, net of effect of acquisitions:			
Accounts receivable	93	30,231	(21,172)
Prepaid expenses and other assets	6,586	15,200	(13,904)
Accounts payable and accrued expenses	(18,586)	(46,123)	22,623
Deferred revenues	(41,773)	(12,347)	47,146
Other current liabilities	(1,427)		
Net cash provided by (used in) operating activities	(26,503)	(71,257)	13,415

Cash flows from investing activities	Granted	-	n/a	n/a	n/a
Exercised	-	n/a	n/a	n/a	
Forfeited	-	n/a	n/a	n/a	
Outstanding and exercisable at 4/30/11	-	$ -	-	$ -	

	Number of Options	Wtd. Avg. Exercise Price	Wtd. Avg. Remaining Contractual Period (Years)	Aggregate Instrinsic Value
Outstanding and exercisable at 7/31/09	1,313	$2.65	0.97	$-
Granted	-	n/a	n/a	n/a
Exercised	-	n/a	n/a	n/a
Forfeited	-	n/a	n/a	n/a
Outstanding and exercisable at 4/30/10	1,313	$2.65	0.22	$-
Outstanding and exercisable at 7/31/10	750	$2.05	0.08	$-
Granted	-	n/a	n/a	n/a
Exercised	-	n/a	n/a	n/a
Forfeited	(750)	2.05	n/a	n/a
Outstanding and exercisable at 4/30/11	-	$-	-	$-

The range of exercise prices for options outstanding under the 1993 Plan at April 30, 2010 was $2.00 to $3.56.

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2000 Stock Option Plan

The Company's 2000 Stock Option Plan ("2000 Plan") had 1,950,000 shares of common stock authorized for issuance. Each incentive stock option that was granted under the 2000 Plan is exercisable for a period of not more than ten years from the date of grant (five years in the case of a participant who is a 10% shareholder of the Company, unless the stock options are nonqualified), or such shorter period as determined by the Compensation Committee, and shall lapse upon the expiration of said period, or earlier upon termination of the participant's employment with the Company. The Company's 2000 Stock Option Plan expired on December 13, 2010, at which time it was terminated except for outstanding options. While options previously granted under the 2000 Plan will continue to be effective through the remainder of their terms, no new options may be granted under the 2000 Plan. Changes in option shares under the 2000 Plan during the three and nine months ended April 30, 2010 and 2011 are as follows:

	Number of Options	Wtd. Avg. Exercise Price	Wtd. Avg. Remaining Contractual Period (Years)	Aggregate Instrinsic Value
Outstanding at 1/31/10	1,291,777	$1.46	6.80	$34,698
Granted	70,250	0.84	n/a	n/a
Exercised	-	n/a	n/a	n/a
Forfeited	(24,750)	1.12	n/a	n/a
Outstanding at 4/30/10	1,337,277	$1.43	6.69	$29,740
Exercisable at 4/30/10	850,626	$1.56	5.56	$24,164
Outstanding at 1/31/11	1,385,119	$1.33	6.41	$35,575
Granted	-	n/a	n/a	n/a
Exercised	-	n/a	n/a	n/a
Forfeited	(92,775)	1.21	n/a	n/a
Outstanding at 4/30/11	1,292,344	$1.34	6.39	$10,535
Exercisable at 4/30/11	893,028	$1.52	5.44	$10,175

	Number of Options	Wtd. Avg. Exercise Price	Wtd. Avg. Remaining Contractual Period (Years)	Aggregate Instrinsic Value
Outstanding at 7/31/09	1,213,402	$1.51	7.08	$21,337
Granted	171,000	0.82	n/a	n/a
Exercised	-	n/a	n/a	n/a
Forfeited	(47,125)	1.28	n/a	n/a
Outstanding at 4/30/10	1,337,277	$1.43	6.69	$29,740
Exercisable at 4/30/10	850,626	$1.56	5.56	$24,164
Outstanding at 7/31/10	1,269,981	$1.41	6.48	$13,319
Granted	146,100	0.64	n/a	n/a
Exercised	-	n/a	n/a	n/a
Forfeited	(123,737)	1.24	n/a	n/a
Outstanding at 4/30/11	1,292,344	$1.34	6.39	$10,535
Exercisable at 4/30/11	893,028	$1.52	5.44	$10,175

The range of exercise prices for options outstanding under the 2000 Plan at April 30, 2011 and 2010 was $0.15 to $2.735.

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Changes in the 2000 Plan's non-vested option shares included in the outstanding shares above during the three and nine months ended April 30, 2010 and 2011 are as follows:

	Number of Options	Wtd. Avg. Exercise Price
Non-vested at 1/31/10	437,526	$ 1.26
Granted	70,250	0.84
Vested	-	n/a
Forfeited	(21,125)	1.28
Non-vested at 4/30/10	486,651	$ 1.21
Non-vested at 1/31/11	422,816	$ 0.94
Granted	-	n/a
Vested	(625)	0.81
Forfeited	(22,875)	0.83
Non-vested at 4/30/11	399,316	$ 0.94

	Number of Options	Wtd. Avg. Exercise Price
Non-vested at 7/31/09	341,776	$ 1.40
Granted	171,000	0.82
Vested	-	n/a
Forfeited	(26,125)	1.28
Non-vested at 4/30/10	486,651	$ 1.21
Non-vested at 7/31/10	282,528	$ 1.09
Granted	146,100	0.64
Vested	(1,125)	1.08
Forfeited	(28,187)	0.85
Non-vested at 4/30/11	399,316	$ 0.94

The weighted average remaining vesting period was 1.12 years at April 30, 2011.

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2010 Stock Option Plan

The Board of Directors adopted the ARI Network Services, Inc. 2010 Equity Incentive Plan (the "2010 Plan") on November 9, 2010, and it was approved by the Company's shareholders in December 2010. The 2010 Plan is the successor to the Company's 2000 Plan.

The 2010 Plan includes the following provisions:

- the aggregate number of shares of Common Stock subject to the 2010 Plan is 650,000 shares;
- the exercise price for options and stock appreciation rights cannot be less than 100% of the fair market value, as defined, of the Company's Common Stock on the date of grant;
- the exercise prices for options and stock appreciation rights cannot be repriced without shareholder approval, except to reflect changes to the capital structure of the Company as described in the 2010 Plan;
- a maximum term of ten years for options and stock appreciation rights;
- a maximum of 325,000 of the shares available for issuance under the 2010 Plan can be in the form of restricted shares or restricted stock units, and the 2010 Plan does not have liberal share counting provisions (such as provisions that would permit shares withheld for payment of taxes or the exercise price of stock options to be re-granted under the plan); and
- awards cannot be transferred to third parties, with the exception of certain estate planning transfers, which can be made if the committee that administers the 2010 Plan approves such transfers.

Changes in option shares under the 2010 Plan during the three and nine months ended April 30, 2011 are as follows:

	Number of Options	Wtd. Avg. Exercise Price	Wtd. Avg. Remaining Contractual Period (Years)	Aggregate Instrinsic Value
Outstanding at 1/31/11	24,500	$0.65	9.97	$2,330
Granted	11,000	0.62	n/a	n/a
Exercised	-	n/a	n/a	n/a
Forfeited	-	n/a	n/a	n/a
Outstanding at 4/30/11	35,500	$0.65	9.79	$-
Exercisable at 4/30/11	-	$-	-	$-

	Number of Options	Wtd. Avg. Exercise Price	Wtd. Avg. Remaining Contractual Period (Years)	Aggregate Instrinsic Value
Outstanding at 7/31/10	-	$-	-	$-
Granted	35,500	0.65	n/a	n/a
Exercised	-	n/a	n/a	n/a
Forfeited	-	n/a	n/a	n/a
Outstanding at 4/30/11	35,500	$0.65	9.79	$-
Exercisable at 4/30/11	-	$-	-	$-

The range of exercise prices for options outstanding under the 2010 Plan at April 31, 2011 was $0.595 to $0.660.

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Changes in the 2010 Plan's non-vested option shares included in the outstanding shares above during the three and nine months ended April 30, 2011 are as follows:

	Number of Options	Wtd. Avg. Exercise Price
Non-vested at 1/31/11	24,500	$ 0.65
Granted	11,000	0.62
Vested	-	-
Forfeited	-	-
Non-vested at 4/30/11	35,500	$ 0.65

	Number of Options	Wtd. Avg. Exercise Price
Non-vested at 7/31/10	-	$ -
Granted	35,500	0.65
Vested	-	-
Forfeited	-	-
Non-vested at 4/30/11	35,500	$ 0.65

The weighted average remaining vesting period was 1.16 years at April 30, 2011.

4. Notes Payable

The following table sets forth certain information related to the Company's debt, derived from our unaudited balance sheet as of April 30, 2011 and audited balance sheet as of July 31, 2010 (in thousands):

	April 30 2011	July 31 2010
Notes payable	$ 5,000	$ 5,000
Less current maturities	745	-
Notes payable non-current	$ 4,255	$ 5,000

We issued a $5,000,000 secured promissory note in connection with the April 27, 2009 acquisition of Channel Blade. The annual interest rate on the note was 10% for the first year and 14% thereafter. Accrued interest only was due quarterly through April 30, 2011. Twenty equal quarterly payments, which will include principal and interest, will then be due, commencing August 1, 2011.

5. Line of Credit

On July 9, 2004, we entered into a line of credit agreement with JPMorgan Chase, N.A. which, as amended, permits us to borrow an amount equal to 80% of the book value of all eligible accounts receivable plus 45% of the value of all eligible open renewal orders (provided the subscription loss rate averaged over the prior three months is less than 4%) minus $75,000, up to $2,000,000. Eligible accounts include certain non-foreign accounts receivable which are outstanding for fewer than 90 days from the invoice date.

The agreement bears interest at 1% per annum above the prime rate (effective rate of 4.25% as of April 30, 2011) plus an additional 3%, at the bank's option, upon the occurrence of any default under the note. The interest rate is subject to a floor equal to the sum of (i) 2.5%; plus (ii) the quotient of: (a) the one month LIBOR rate divided by (b) one minus the maximum aggregate reserve requirement imposed under Regulation D of the Board of Governors of the Federal

Reserve System (effective floor of 2.8% as of April 30, 2011). The agreement includes a non-usage fee of 0.25% per annum on any unused portion of the line of credit. The line of credit terminates June 30, 2012. The line of credit is secured by substantially all assets of the Company and limits repurchases of Common Stock, the payment of dividends, liens on assets and new indebtedness. It also contains a financial covenant requiring us to maintain a minimum debt service coverage ratio of 1.2, with which we were in compliance at April 30, 2011. There was $500,000 and $1,025,000 principal outstanding on the line of credit at April 30, 2011 and July 31, 2010, respectively. There was $1,500,000 remaining available per the terms of the agreement on the line of credit at April 30, 2011.

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6. Shareholder Rights Plan

On August 7, 2003, we adopted a Shareholder Rights Plan designed to protect the interests of common shareholders from an inadequate or unfair takeover, but not affect a takeover proposal which the Board of Directors believes is fair to all shareholders. Under the Shareholder Rights Plan adopted by the Board of Directors, all shareholders of record on August 18, 2003 received one Preferred Share Purchase Right for each share of common stock they owned. These Rights trade in tandem with the common stock until and unless they are triggered. Should a person or group acquire more than 10% of ARI's common stock (or if an existing holder of 10% or more of the common stock were to increase its position by more than 1%), the Rights would become exercisable for every shareholder except the acquirer that triggered the exercise. The Rights, if triggered, would give the rest of the shareholders the ability to purchase additional stock of ARI at a substantial discount. The rights will expire on August 18, 2013, and can be redeemed by the Company for $0.01 per Right at any time prior to a person or group becoming a 10% shareholder.

7. Income Taxes

The unaudited provision for income taxes for the three and nine months ended April 30, 2011 and 2010 is composed of the following (in thousands):

	Three months ended April 30		Nine months ended April 30	
	2011	2010	2011	2010
Current:				
Federal	$-	$-	$-	$-
State	(12)	-	(22)	(1)
Change in the beginning deferred tax asset valuation allowance	-	79	137	371
Deferred, net	(390)	(79)	(596)	(375)
Income tax benefit (expense) from continuing operations	$(402)	$-	$(481)	$(5)
Income tax benefit (expense) from discontinued operations (1)	$(15)	$-	$(15)	$-

The provision for income taxes is based on taxes payable under currently enacted tax laws and an analysis of temporary differences between the book and tax bases of the Company's assets and liabilities, including various accruals, allowances, depreciation and amortization, and does not represent current taxes due. The tax effect of these temporary differences and the estimated tax benefit from tax net operating losses are reported as deferred tax assets and liabilities in the balance sheet. We have unused net operating loss carry forwards for federal income tax purposes of approximately $16,745,000 expiring through 2031, a large portion of which expire by 2013. As a result, we generally only incur alternative minimum taxes.

An assessment is performed semi-annually of the likelihood that our net deferred tax assets will be realized from future taxable income. To the extent management believes it is more likely than not that some portion, or all, of the deferred tax asset will not be realized, a valuation allowance is established. This assessment is based on all available evidence, both positive and negative, in evaluating the likelihood of realizability. Issues considered in the assessment include future reversals of existing taxable temporary differences, estimates of future taxable income (exclusive of reversing temporary differences and carryforwards) and prudent tax planning strategies available in future periods. Because the ultimate realizability of deferred tax assets is highly subject to the outcome of future events, the amount established as a valuation allowance is considered to be a significant estimate that is subject to change in the near term. To the extent a valuation allowance is established or there is a change in the allowance during a period, the change is reflected with a corresponding increase or decrease in the tax provision in the Consolidated Statements of Income. We will continue to evaluate the realizability of our deferred tax assets on a semi-annual basis. There was no assessment made to evaluate the realizability of our deferred tax assets during the quarter ended April 30, 2011.

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8. Business Segments

Our business segments are internally organized primarily by geographic location of the operating facilities. In accordance with GAAP regarding disclosures about business segments, we have segregated the Netherlands operation and the United States operations into separate reportable segments. Segment revenue for the Netherlands operation includes only revenue generated out of the Netherlands subsidiary and does not include rest of world revenue sold by the United States operation. We evaluate the performance of and allocate resources to each of the segments based on their operating results.

Information concerning our operating business segments is as follows for the periods indicated (in thousands):

	(Unaudited) Three months ended April 30		(Unaudited) Nine months ended April 30	
	2011	2010	2011	2010
Revenue from continuing operations				
Netherlands	$206	$168	$579	$525
United States	5,148	5,184	15,337	15,598
Consolidated	$5,354	$5,352	$15,916	$16,123

	(Unaudited) Three months ended April 30		(Unaudited) Nine months ended April 30	
	2011	2010	2011	2010
Net income (loss) from continuing operations				
Netherlands	$(21)	$(42)	$(75)	$(113)
United States	537	197	813	932
Consolidated	$516	$155	$738	$819

	(Unaudited) April 30 2011	(Audited) July 31 2010
Total Assets		
Netherlands	$ 311	$ 328
United States	18,640	19,449
Consolidated	$ 18,951	$ 19,777

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9. Restructuring

July 2008 Restructuring

In July 2008, ARI announced a restructuring that consolidated our data conversion operations in Williamsburg, Virginia into our Wisconsin location and consolidated our software development operations in Colorado Springs, Colorado into our Cypress, California location. The following represents changes to the restructuring reserve, which were included in other accrued liabilities on the balance sheet and have been fully paid as of April 30, 2011 (in thousands):

	Three months ended April 30		Nine months ended April 30	
	2011	2010	2011	2010
Beginning Balance	$ 40	$ 112	$ 80	$ 93
Payments	(40)	(30)	(99)	(87)
Adjustments	-	-	19	76
Ending Balance	$ -	$ 82	$ -	$ 82

During the nine months ended April 30, 2011 and 2010, we increased the July 2008 restructuring reserve by $19,000 and $76,000, respectively, to adjust for the estimated remaining payments due on our vacant Colorado Springs facility, which were paid in full in April 2011.

July 2010 Restructuring

In July 2010, in an effort to focus on our core business, which includes electronic catalogs, websites, and lead management services, we undertook a workforce reduction and business improvement initiative. This initiative included the divestiture of AFIS and the write off of certain components of capitalized software related to products no longer in use or with limited future cash flows that are no longer considered a part of our core operation.

The following represents changes to the July 2010 restructuring reserve, as originally scheduled, related to severance and related benefits from the continuing operation, which was included in accrued payroll and related liabilities on the balance sheet and paid in full during the quarter ended April 30, 2011 (in thousands):

	Three months ended April 30, 2011	Nine months ended April 30, 2011
Beginning Balance	$ 24	$ 147
Payments	(24)	(147)
Ending Balance	$ -	$ -

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The following represents changes to the July 2010 restructuring reserve related to the AFIS divestiture, as adjusted for expenses that were less than originally estimated, which were included in other accrued liabilities on the balance sheet and paid in full during the quarter ended April 30, 2011 (in thousands):

	Three months ended April 30, 2011	Nine months ended April 30, 2011
Beginning Balance	$ 40	$ 110
Payments	-	(51)
Adjustments	(40)	(59)
Ending Balance	$ -	$ -

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10. Disposition of a Component of an Entity

On March 1, 2011, we entered into an Asset Purchase Agreement (the "Agreement") with Globalrange Corporation ("Globalrange"). Under the terms of the Agreement, we sold to Globalrange certain rights and assets relating to our electronic data interchange business for the agricultural chemicals industry (the "AgChem EDI Business"). Because the AgChem EDI Business was not a separate entity or reportable segment, the transaction was recorded as a disposition of a component of an entity.

As part of the purchase price for the AgChem EDI Business, Globalrange agreed to assume certain liabilities of ARI relating to the AgChem EDI Business, primarily consisting of unearned revenues (as defined in the Agreement). Globalrange will make earn-out payments to ARI annually over a four-year period following the closing date, with an initial pre-payment of $80,000. The amounts of such earn-out payments will be determined based on collections received by Globalrange relating to the AgChem EDI Business during such period, and will be subject to a floor and cap, in accordance with the terms of the Agreement.

The earn-out was estimated at $580,000 less an imputed discount of $97,000, based on the present value of the estimated earn-out payments, discounted at 14%, which is the prevailing rate of interest charged on the Company's debt. The remaining balance of the estimated earn-out receivable includes $133,000 in Prepaid Expenses and Other Short Term Assets and $228,000 in Other Long Term Assets at April 30, 2011. We recorded a gain on the disposition of the AgChem EDI Business of $433,000 or $0.05 per share before tax.

11. Discontinued Operations

On July 27, 2010, we divested AFIS, which offered dealer F&I services. The divestiture resulted in a loss from discontinued operations of $1,000, which was recorded in the fourth quarter of fiscal 2010. The results of operations of AFIS, which were previously reported within the United States business segment, have been reflected as a discontinued operation in our consolidated financial statements for all periods presented.

The following table represents the results of operations of AFIS for the three and nine months ended April 30, 2010 (in thousands):

	(Unaudited) Three months ended April 30		(Unaudited) Nine months ended April 30	
	2011	2010	2011	2010
Revenues	$ -	$ 26	$ -	$ 80
Cost of sales	-	4	-	9
Operating expenses	-	151	-	526
Operating loss	-	(129)	-	(455)
Restructuring income	40	-	40	-
Income tax expense	(15)	-	(15)	-
Net benefit (loss)	$ 25	$ (129)	$ 25	$ (455)

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of our results of operations and financial condition should be read together with our unaudited consolidated financial statements for the three and nine months ended April 30, 2011 and 2010, including the notes thereto, which appear elsewhere in this quarterly report on Form 10-Q. This discussion contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"). All statements other than statements of historical facts are statements that could be deemed to be forward-looking statements. These statements are based on current expectations, estimates, forecasts, and projections about the markets in which we operate and the beliefs and assumptions of our management. Words such as "expects," "anticipates," "targets," "goals," "projects," "intends," "plans," "believes," "seeks," "estimates," "endeavors," "strives," "may," variations of suc similar expressions are intended to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances are forward-looking statements. Readers are cautioned that these forward-looking statements are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict, estimate, or verify, including those identified in our annual report on Form 10-K for the year ended July 31, 2010, under "Item 1A. Risk Factors,", and elsewhere herein. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason.

Overview of Business

ARI Network Services, Inc. ("ARI") provides technology-enabled solutions that help dealers, distributors and manufacturers worldwide increase revenue and reduce costs. We deliver our products and services to companies of all sizes across a dozen vertical markets, with a core emphasis on the outdoor power, power sports, marine, RV, and appliance verticals. We estimate that 18,000 equipment dealers, 125 manufacturers, and 150 distributors worldwide leverage our solutions to drive revenue, increase efficiencies and improve customer satisfaction.

Our Solutions

Our technology-enabled solutions are designed to facilitate our customers' operations, from lead generation and lead management, to sales of their whole goods, parts, garments, and accessories ("PG&A"). To achieve this, our products and services allow our customers to: (i) efficiently market to their customers and prospects in order to drive increased traffic to their location or website; (ii) manage and nurture customers and prospects; (iii) increase revenues by selling PG&A products online; (iv) increase revenues by generating leads for whole goods; and (v) increase revenues and reduce costs by enhancing the productivity of our customers' support operations, specifically with respect to the sale of manufacturers' parts.

Today, we generate revenue from three primary categories of technology-enabled solutions: (i) electronic catalogs for publishing, viewing and interacting with technical reference information about equipment; (ii) lead generation and management products and services designed to help dealers grow their businesses and increase profitability through efficient marketing of their products; and (iii) websites with eCommerce capabilities designed to generate sales through the sites and provide information to consumers in the dealers' local areas. Further information regarding our service offerings can be accessed at the Company's website at www.arinet.com, or in our Annual Report on Form 10-K for the year ended July 31, 2010.

Our Strategy

Our mission is to be recognized in each market we serve as the leader in creating, marketing and supporting solutions that increase revenue and reduce costs for our customers. To do this, our technology-enabled products and services create connections between manufacturers, distributors, dealers and their end-customers. We expect to increase our financial and market performance by executing on the key elements of our strategy, which include:

- Deepening relationships with our existing customer base through launching new technology-enabled products and services and cross-selling complementary products and services across customers and markets; this will improve the value proposition to the customer and will foster organic growth and reduce customer churn rates in our strategic, subscription-based products and services;

- Continuing to execute on our current sales strategy with a focus on growing our customer base and increasing monthly recurring revenue ("MRR");

- Refining our organization and processes to drive innovation and efficiency, which will include providing operational focus on our high gross margin, critical nature, recurring revenue products into the markets we serve; and

- Pursuing strategic acquisitions that will allow us to expand our addressable market and customer base.

Our 2009 acquisition of Channel Blade and our 2008 acquisition of the electronic parts catalog and eCommerce assets of Info Access expanded not only our product offerings but the number of markets we serve. As a result of those acquisitions, ARI is the market leader in the marine, RV and appliance markets. Moving forward we expect to launch additional technology-enabled products and services that fit into our strategy of deepening our relationships with our customers.

Our Competitive Strengths

Market Leader in Core Verticals

We believe that we are one of the leaders in each of our core vertical markets and also believe we are the market leader in the outdoor power and marine markets. Our direct relationships with approximately 18,000 dealers, 125 manufacturers, and 150 distributors allow us to cost-effectively leverage our published catalog content into a large and diversified customer base and to launch new product enhancements and technology-enabled solutions to this customer base.

Breadth and Depth of Published Content

The breadth and depth of our catalog content, as well as our ability to efficiently publish manufacturers' PG&A data as it becomes available, provides ARI with a critical competitive advantage. Our electronic catalog content enables multi-line dealers to easily access catalog content for multiple manufacturers using a single software platform. This advantage provides "stickiness" to our catalog customer base that allows us to efficiently and cost effectively nurture our existing customers while devoting resources to develop new products and services, enabling us to grow our overall customer base.

Recurring Revenue Model

A substantial portion of our revenue is subscription-based and recurring revenue. The majority of our customers are on contracts of twelve months or longer, and these contracts typically auto-renew for additional twelve month terms. This provides us with advanced visibility into our future revenues and, when coupled with a low rate of customer churn, significantly reduces the cost to maintain and nurture our customer base. This frees up resources to enhance our existing products and work toward new product innovations.

Suite of Products Covers Entire Sales Cycle

Our suite of dealer products and services and eCommerce capabilities enhance our customers' front office operations by covering the entire sales cycle, from lead generation and lead management to sales of PG&A to the consumer, both in-store and online.

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Our Markets and the Challenges We Face

Competition for our products and services varies by product and by vertical market. We believe that no single competitor today competes with us on every product and service in each of our industry verticals. In electronic catalogs, we compete primarily with Snap-on Business Solutions, which designs and delivers electronic parts catalogs, accessory sales tools, and manufacturer network development services, primarily to the automotive, power sports, outdoor power, construction, agriculture and mining markets. In addition, there is a variety of smaller companies focused on one or two specific industries.

In lead management, websites and eCommerce, our primary competitors are PowerSports Network, owned by Dominion Enterprises, and 50 Below. Competition for our website development services also comes from in-house information technology groups that may prefer to build their own web-based proprietary systems, rather than use our proven industry solutions. There are also large, general market eCommerce companies, such as IBM, which offer products and services that could address some of our customers' needs. These general eCommerce companies do not typically compete with us directly, but they could decide to do so in the future.

Two of the markets we serve, marine and RV, have been hard hit by the economy the past several years, given the "luxury" nature of the products in those verticals. As a result, in fiscal 2010 we experienced an increase in customer churn due to manufacturer bankruptcies, dealer closures, and extreme cost reduction measures by our dealers. We have begun to see improvements in customer churn during the first nine months of fiscal 2011. To the positive, the impacts of a difficult economic environment have been somewhat softened by the consumers' willingness in a down economy to repair existing equipment rather than purchase new equipment, which serves to amplify the importance of our published parts content provided to customers via our catalog parts lookup products and our website products.

Results of Operations

Summary

The fiscal 2011 third quarter represented another quarter of strong operating results. These results are a reflection of the continued execution of our fiscal 2011 strategy and include:

- We continued to generate significant operating cash flows, which we deployed on product development, technology infrastructure upgrades and paying down our line of credit. Cash flows from operations were $862,000 and $2,158,000 for the three and nine month periods ended April 30, 2011, versus $950,000 and $1,145,000 during the same periods last year. This represents a 97% increase on a year to date basis. In addition to investments in product development and our technology infrastructure, we paid down $525,000 on our line of credit during the first nine months of fiscal 2011, whereas last year we borrowed $525,000 over the same period to fund our operations.

- Revenues for the quarter ended April 30, 2011 were comparable to last year at $5,354,000 and declined 1.3% on a year to date basis from $16,123,000 for the nine months ended April 30, 2010 to $15,916,000 for the nine months ended April 30, 2011. The year to date decline in revenues was primarily attributed to the loss of revenues associated with the non-cash amortization of deferred revenue established at the time of the Channel Blade acquisition. We recognized revenues of $13,000 and $49,000 from the amortization of this liability for the three and nine months ended April 30, 2011, versus $122,000 and $762,000 for the same periods last year. This represents revenue declines of $109,000 and $713,000 for the relative year over year periods. In addition to this, we sold our Agchem EDI business on March 1, 2011, which resulted in a revenue decline of approximately $80,000 for the relative year over year periods. Without the effects of the Channel Blade deferred revenue and the disposition of the Agchem EDI Business, we had organic revenue growth of approximately 4% for the three and nine month periods ended April 30, 2011, compared to the same periods last year.

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- Operating income for the third quarter of fiscal 2011 was $675,000, compared to $297,000 for the same period last year, an increase of 127%. On a year to date basis, operating income was $1,374,000, compared to $1,258,000 for the same period last year, an increase of 9%. Excluding the aforementioned loss of deferred revenue, operating income for the three and nine month periods ended April 30, 2011 would have increased $487,000 and $828,000 over the same periods last year, increases of 278% and 167%, respectively. This improvement can be attributed to the identification and execution of operational efficiencies and cost reduction strategies throughout the organization, including: (i) the fiscal 2010 restructuring and discontinuation of the F&I business; (ii) the data center consolidation project; (iii) completing the Channel Blade integration; and (iv) continuous focus on achieving additional operational efficiencies.

- Net income for the third quarter was $541,000, or $.07 per share, compared to $26,000, or $.00 per share last year. For the nine months ended April 30, 2011, net income was $763,000, or $.10 per share, versus $364,000, or $.05 per share for the same period last year. In addition to the improvements in operating income, the year over year growth in net income is due to the gain recorded on the sale of the Agchem EDI business and the discontinuation of the F&I business, which generated losses up until its disposition. These income enhancements were partially offset by increases in interest and income tax expenses.

We expect continued improvements in revenue, operating income and cash generation for the remainder of fiscal 2011, relative to fiscal 2010, due to continued focus on providing innovative products and services, outstanding customer support and by driving operational efficiencies throughout the organization.

Net Revenues and Gross Margins

The following table summarizes our net revenues, gross profit and gross margin percentage by major product category (in thousands):

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	(Unaudited) Three months ended April 30			(Unaudited) Nine months ended April 30		
	2011	2010	Percent Change	2011	2010	Percent Change
Catalog						
Revenue	$3,151	$3,166	-0.5 %	$9,390	$9,350	0.4 %
Cost of revenue	347	409	-15.2 %	1,148	1,159	-0.9 %
Gross profit	2,804	2,757	1.7 %	8,242	8,191	0.6 %
Gross margin percentage	89.0 %	87.1 %		87.8 %	87.6 %	
Website						
Revenue	1,308	1,230	6.3 %	3,665	4,065	-9.8 %
Cost of revenue	336	287	17.1 %	818	742	10.2 %
Gross profit	972	943	3.1 %	2,847	3,323	-14.3 %
Gross margin percentage	74.3 %	76.7 %		77.7 %	81.7 %	
Lead management						
Revenue	247	256	-3.6 %	656	735	-10.8 %
Cost of revenue	87	29	200.0 %	211	80	163.8 %
Gross profit	160	227	-29.6 %	445	655	-32.1 %
Gross margin percentage	64.8 %	88.7 %		67.8 %	89.1 %	
Other						
Revenue	648	700	-7.4 %	2,205	1,973	11.7 %
Cost of revenue	325	395	-17.7 %	1,171	1,063	10.2 %
Gross profit	323	305	5.9 %	1,034	910	13.6 %
Gross margin percentage	49.8 %	43.6 %		46.9 %	46.1 %	
Total						
Revenue	5,354	5,352	0.0 %	15,916	16,123	-1.3 %
Cost of revenue	1,095	1,120	-2.2 %	3,348	3,044	10.0 %
Gross profit	$4,259	$4,232	0.6 %	$12,568	$13,079	-3.9 %
Gross margin percentage	79.5 %	79.1 %		79.0 %	81.1 %	

Total revenues for the three and nine months ended April 30, 2011 were $5,354,000 and $15,916,000, respectively, versus $5,352,000 and $16,123,000 for the same periods last year. As previously discussed, our fiscal 2011 revenues were negatively affected by the loss of non-cash deferred revenues and the sale of our Agchem EDI Business. Excluding the impact of these items, we would have experienced organic revenue growth of approximately 4% for both the three and nine months ended April 30, 2011, which is attributed to continued strong new sales and improvement in our rate of customer churn, which have collectively led to continued growth in our MRR. Given that a substantial portion of our revenues are subscription-based, MRR is one of the performance indicators we closely monitor, as it is the key driver of future revenue growth.

Catalog, which continues to be our largest source of revenue, was relatively flat for the three and nine months ended April 30, 2011, compared to the same periods last year. We experienced an increase in new recurring subscription sales from our international and US operations, which was offset by a decline in revenue from non-recurring professional services as we focused on growing MRR, rather than non-recurring revenue. We expect to see continued year over year growth in our catalog revenues for the remainder of fiscal 2011, as we focus on growing our MRR.

Website revenues increased 6.3% for the three month period ended April 30, 2011, but declined 9.8% for the nine months ended April 30, 2011, compared to the same periods last year. The year to date decrease in revenue is due to the decline in non-cash deferred revenues previously discussed. Without this item, year to date revenues would have increased 9.5%. Recurring revenues increased 14.3% and 5.1% for the three and nine month periods ended April 30, 2011, compared to the same periods last year due to strong new sales and an improvement in customer churn. Furthermore, the non-cash, non-recurring revenues were replaced with cash-generating MRR. We expect total website revenue to increase for the remainder of fiscal 2011, over the previous year, due to the anticipated continued improvement in both recurring revenue and churn.

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Revenues from our Lead Management product decreased 3.6% and 10.8% for the three and nine month periods ended April 30, 2011, compared to the same periods last year. Much of Lead Management sales are from the marine industry, which has been adversely affected by the economic conditions of the past several years. We experienced increased churn in this product during the latter half of fiscal 2010, which had a negative impact on revenues during fiscal 2011. We expect revenues from our Lead Management product to remain at their current levels for the remainder of fiscal 2011. Although we do not anticipate year over year growth in fiscal 2011, we have plans to launch a new platform of our Lead Management product, which is expected to drive growth beginning in fiscal 2012.

Other revenues decreased 7.4% for the three month period ended April 30, 2011, compared to the same period last year, due to the sale of the Agchem EDI business. Other revenues included Agchem EDI revenues of $118,000 and $360,000 or $0.02 and $0.05 of revenue per share for the three and nine month periods ended April 30, 2010 compared to $38,000 and $276,000 or $0.00 and $0.03 of revenue per share for same periods this year. Other revenues increased for the nine month period ended April 30, 2011, compared to the same periods last year due to an increase in revenues from our search engine product and a website customization project for a large manufacturer. We expect to see revenues in this category increase for the remainder of fiscal 2011 due to the recognition of revenues from a recently-signed professional services contract.

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The table below breaks out cost of revenues for the three and nine months ended April 30, 2011 and 2010 (in thousands):

	(Unaudited) Three months ended April 30				(Unaudited) Nine months ended April 30			
	2011	Percent of Revenue	2010	Percent of Revenue	2011	Percent of Revenue	2010	Percent of Revenue
Net revenue	$5,354		$5,352		$15,916		$16,123	
Cost of revenues:								
Amortization of capitalized software costs	291	5.4 %	265	5.0 %	815	5.1 %	784	4.9 %
Direct labor	378	7.1 %	401	7.5 %	966	6.1 %	1,041	6.5 %
Other direct costs	426	8.0 %	454	8.5 %	1,567	9.8 %	1,219	7.6 %
Total cost of revenues	1,095	20.5 %	1,120	20.9 %	3,348	21.0 %	3,044	18.9 %
Gross profit	$4,259	79.5 %	$4,232	79.1 %	$12,568	79.0 %	$13,079	81.1 %

Gross profit was $4,259,000 or 79.5% of revenue for the three months ended April 30, 2011, compared to $4,232,000 or 79.1% of revenue for the same period last year. Gross profit was $12,568,000 or 79.0% of revenue for the nine months ended April 30, 2011, compared to $13,079,000 or 81.1% of revenue for the same period last year. The year to date decline in gross profit, as well as the decline in gross profit margin, was primarily attributed to two factors: (i) the loss of the non-cash deferred revenues, for which there were no costs associated; and (ii) a change in product mix in which we saw an increase in revenues from some of our lower-margin products. We expect fluctuations in gross margin from quarter to quarter and year over year based on the mix of products sold, but expect our gross margins to improve over time as we focus our sales efforts on our higher margin, recurring revenue products.

Operating Expenses

The following table summarizes our unaudited operating expenses by expense category (in thousands):

	(Unaudited) Three months ended April 30					(Unaudited) Nine months ended April 30				
	2011	Percent of Revenue	2010	Percent of Revenue	Percent Change	2011	Percent of Revenue	2010	Percent of Revenue	Percent Change
Sales and marketing	$946	17.7 %	$1,261	23.6 %	-25.0 %	$3,172	19.9 %	$3,595	22.3 %	-11.8 %
Customer operations and support (1)	834	15.6 %	812	15.2 %	2.7 %	2,545	16.0 %	2,468	15.3 %	3.1 %
Software development and technical support (2)	351	6.6 %	245	4.6 %	43.3 %	1,127	7.1 %	1,076	6.7 %	4.8 %
	1,011	18.9 %	1,206	22.5 %	-16.2 %	3,091	19.4 %	3,374	20.9 %	-8.4 %

General and administrative										
Restructuring (3)	-	n/a	-	n/a	n/a	-	n/a	76	0.5 %	n/a
Depreciation and amortization (4)	442	8.3 %	411	7.7 %	7.5 %	1,259	7.9 %	1,232	7.6 %	2.2 %
Net operating expenses	$3,584	66.9 %	$3,935	73.5 %	-8.9 %	$11,194	70.3 %	$11,821	73.3 %	-5.3 %

(1) Net of capitalized software development costs of $41, $10, $143 and $61 for the three and nine months ended April 30, 2011 and 2010, respectively.

(2) Net of capitalized software development costs of $372, $380, $1,085 and $954 for the three and nine months ended April 30, 2011 and 2010, respectively.

(3) Represents an adjustment to accrued rent related to the 2008 restructuring.

(4) Exclusive of amortization of software products of $291, $265, $815 and $784 for the three and nine months ended April 30, 2011 and 2010, respectively, which are included in cost of revenue.

Net operating expenses decreased from $3,935,000 or 73.5% of revenue for the three month period ended April 30, 2010 to $3,584,000 or 66.9% of revenue for the same period this year and from $11,821,000 or 73.3% of revenue for the nine month period ended April 30, 2010 to $11,194, 000 or 70.3% of revenue for the same period this year. The decrease in net operating expenses is due to a decrease in sales and marketing and general and administrative expenses, both of which are discussed below.

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Sales and marketing expenses declined $315,000 or 25.0%, for the three months ended April 30, 2011 and $423,000 or 11.8% for the nine months ended April 30, 2011, compared to the same periods last year. We measure the returns realized through our sales teams with the customer acquisition cost ("CAC") ratio. This is defined as the new annualized net gross margin added during a quarter divided by the sales and marketing costs of the previous quarter, excluding any account management costs associated with your base revenue. We have experienced an improvement in our CAC ratios for the quarter ended April 30, 2011, compared to the same period last year, which means that we are generating more sales for each sales and marketing dollar spent. These improvements in CAC were achieved by refining our sales incentive programs, achieving operating efficiencies and close management of discretional sales and marketing spending.

Our software development and technical support staff have three essential responsibilities for which the accounting treatment varies depending upon the work performed: (i) costs associated with internal software development efforts are typically capitalized as software product costs and amortized over the estimated useful life of the product; (ii) professional services performed for customers related to software customization projects are classified as cost of revenues; and (iii) all other activities are considered operating expenses and included within the software development and technical support operating expense category.

The table below summarizes our gross software development and technical support spending (in thousands):

	(Unaudited) Three months ended April 30			(Unaudited) Nine months ended April 30		
	2011	2010	Percent Change	2011	2010	Percent Change
Total software development and technical support costs	$1,130	$1,009	12.0 %	$3,328	$3,080	8.1 %
Less: amount capitalized as software development	(425)	(390)	9.0 %	(1,278)	(1,015)	25.9 %
Less: direct labor classified as cost of revenues	(354)	(374)	-5.3 %	(923)	(989)	-6.7 %
Net software development and technical support costs classified as operating expenses	$351	$245	43.3 %	$1,127	$1,076	4.8 %

We increased our total software development and technical support costs for the three and nine months ended April 2011, compared to the same periods last year, in accordance with our product development and innovation strategies. We expect fluctuations in the amount of software development and technical support costs classified as operating expenses from period to period, as the mix of development and customization activities will change based on customer requirements, even if total software development and technical support departmental costs remain relatively constant.

During the three and nine months ended April 30, 2011, we capitalized $375,000 and $1,228,000 of software development labor and overhead, versus $390,000 and $1,015,000 for the same periods last year. As discussed earlier, we completed several significant product upgrades and enhancements during fiscal 2011 and are working on several new enhancements expected to be released in the upcoming quarter, which we anticipate will increase future revenues for the Company. Management expects total spending for software development and technical support to continue at the same pace for the remainder of fiscal 2011 as we focus on our core strategy of product enhancement and innovation.

General and administrative expenses declined $195,000 or 16.2% for the three months ended April 30, 2011 and $283,000 or 8.4% for the nine months ended April 30, 2011, compared to the same periods last year. This improvement can be attributed to management's cost reduction strategies and operational efficiencies in the general and administrative area, primarily as a result of the restructurings and the integration of the Channel Blade acquisition.

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We expect operating expenses to continue to decrease over the prior year for the remainder of fiscal 2011 as a result of operational efficiencies, including our data center consolidation, our focus on eliminating non-value added costs and operational process improvements made throughout the organization.

Other Income (Expense)

Other income included an estimated gain before tax of approximately $433,000 or $0.05 per share on the sale of the AgChem EDI business during the quarter ended April 30, 2011, as more fully discussed in Note 10 to our Unaudited Consolidated Financial Statements.

Income Taxes

Current income tax expense is the statutory tax rate applied to current U.S. income before taxes, plus or minus any adjustments to the deferred tax assets and to the estimated valuation allowance against deferred tax assets. This does not represent a current cost obligation, as we have net operating loss carryforwards to offset taxable income. We recorded income tax expense from continuing operations of $402,000 during the quarter ended April 30, 2011 and $481,000 for the nine months ended April 30, 2011, compared to expense of $0 and $5,000 for the same periods last year.

Liquidity and Capital Resources

The following table sets forth, for the periods indicated, certain unaudited cash flow information derived from our financial statements (in thousands):

	(Unaudited) Three months ended April 30			(Unaudited) Nine months ended April 30		
	2011	2010	Percent Change	2011	2010	Percent Change
Net cash provided by operating activities	$862	$950	-9.3 %	$2,158	$1,145	88.5 %
Net cash used in investing activities	(567)	(582)	2.6 %	(1,612)	(1,499)	-7.5 %
Net cash provided by (used in) financing activities	(720)	(38)	-1794.7 %	(676)	611	-210.6 %
Effect of foreign currency exchange rate changes on cash	2	(3)	166.7 %	(4)	(3)	n/a
Net change in cash	$(423)	$327	-229.4 %	$(134)	$254	-152.8 %
Cash at end of period	$804	$904	-11.1 %	$804	$904	-11.1 %

Total cash flow for the three months ended April 30, 2011 was a net use of $423,000, compared to a net generation of $327,000 for the same period last year. For the nine months ended April 30, 2011, total cash flow was a net use of $134,000, versus a net generation of $254,000 last year. The primary driver of the year over year decrease in cash flow is the $525,000 repayment on the line of credit made during fiscal 2011 versus borrowings of $525,000 on the line of credit during fiscal 2010.

Cash generated from operations was $862,000 for the three month period ended April 30, 2011, which was relatively the same as last year. Cash generated from operations increased 97% from $1,145,000 for the nine months ended April 30, 2010 to $2,158,000 for the same period this year. The substantial improvement in operating cash flows was driven by the following factors:

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(i) A greater portion of our revenues in fiscal 2011 resulted in cash collected. This was due to the fact that a substantial portion of the non-cash deferred revenues we recognized in fiscal 2010 were replaced with cash-generating MRR.

(ii) We sold AFIS in July 2010. In fiscal 2010, this business generated pre-tax operating losses of $653,000, of which $455,000 were incurred in the first nine months.

(iii) Our operating expenses continue to decline as we focus on efficiencies throughout the organization.

(iv) The Channel Blade acquisition has been fully integrated into the organization.

(v) Our accounts receivable collections have improved as we expanded our efforts in this area. This improvement is reflected by the 37% decline in accounts receivable, net of bad debt allowance.

We continue to invest cash in the business, primarily for the development of new products and upgrades of existing products; however, we have also invested additional funds during fiscal 2011 in upgrading our technology infrastructure as part of our efforts to consolidate our data centers. These efforts will result in our primary data center being located in a Tier III (as defined by the Uptime Institute's tier classification system) hosted facility in Madison, Wisconsin with one internally-hosted backup data center. Although we will continue to invest in the business, management expects cash used in investing activities to fluctuate from period to period based on the level of software development activities as well as the timing of acquisitions.

Cash used in financing activities was $720,000 for the three month period ended April 30, 2011 versus $38,000 for the same period last year and $676,000 for the nine month period ended April 30, 2011 versus cash generated from financing activities of $611,000 for the same period last year. Cash generated in fiscal 2010 was a result of borrowings on the line of $525,000, whereas cash was used in financing in fiscal 2011 to pay back $525,000 on our line of credit.

Management believes that current cash balances, as well as the existing availability under our line of credit with JPMorgan Chase, are sufficient to fund our needs over the next twelve months.

Off-Balance Sheet Arrangements

The Company has no significant off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on its financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Not Applicable.

Item 4. Controls and Procedures

We have established disclosure controls and procedures to ensure that material information relating to us, including our consolidated subsidiaries, is made known on a timely basis to the officers who certify our financial reports and to other members of senior management and the Board of Directors.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures are effective (1) in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act and (2) to ensure that information required to be disclosed in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

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There have not been any changes in our internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) that occurred during our quarter ended April 30, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, the Company may be involved in litigation relating to claims arising out of its operations in the usual course of business. No material legal proceedings to which the Company is a party arose during the three months ended April 30, 2011.

Item 1A. Risk Factors

The Company's risks and uncertainties are described in full detail in Item 1A of our annual report on Form 10-K for the fiscal year ended July 31, 2010. There have been no significant changes to the risks described in Item 1A of our annual report on Form 10-K for the fiscal year ended July 31, 2010.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults upon Senior Securities

None.

Item 4. Removed and Reserved

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

2.1	Asset Purchase Agreement dated as of March 1, 2011, by and between Globalrange Corporation and ARI Network Services, Inc., incorporated by reference to ARI's current report on Form 8-K filed on March 4, 2011.
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer.
32.1	Section 1350 Certification of Chief Executive Officer.
32.2	Section 1350 Certification of Chief Financial Officer.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on this 14th day of June, 2011.

ARI NETWORK SERVICES, INC.
(Registrant)

By: /s/ Roy W. Olivier
Roy W. Olivier
President and Chief Executive Officer

By: /s/ Darin R. Janecek
Darin R. Janecek
Vice President of Finance and Chief Financial Officer