EVOLVE SOFTWARE INC
Form 10-Q
November 14, 2001

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2001

OR

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

FOR THE TRANSITION PERIOD FROM __________ TO _________

COMMISSION FILE NUMBER: 000-31155

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

DELAWARE	94-3219745
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1400 65TH STREET, SUITE 100, EMERYVILLE, CA	94608
(Address of principal executive offices)	(Zip Code)

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

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

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

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

The aggregate market value of the voting common stock held by non-affiliates of the registrant as of November 12, 2001, was approximately $6,431,080 based upon the closing sale price reported for that date on the NASDAQ National Market. Shares of common stock held by each officer and director and by each person who owns more than 5% or more of the outstanding common stock have been excluded because such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily conclusive for other purposes.

The number of shares outstanding of the registrant's common stock as of November 12, 2001, was 40,830,111.

EVOLVE SOFTWARE, INC.

FORM 10-Q

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PART I - FINANCIAL INFORMATION

ITEM1. FINANCIAL STATEMENTS

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

	2001	
	SEPTEMBER 30,	JUNE 30,

ASSETS	(unaudited)	
Current assets:		
Cash and cash equivalents	$ 10,867	$ 19,914
Short-term investments	861	2,840
Accounts receivable, net of allowance for doubtful accounts $1,275 and $730, respectively. . . .	3,636	6,414
Prepaid expenses and other current assets	2,527	2,454
Notes receivable from related party	175	175
Total current assets.	18,066	31,797
Property and equipment, net	9,632	10,481
Deposits and other assets	1,588	1,617
Goodwill and other intangible assets, net	3,325	3,726
Total assets.	$ 32,611	$ 47,621
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable.	$ 4,250	$ 5,670
Accrued liabilities	4,943	5,852
Deferred revenues	6,207	8,117
Capital lease obligations, current portion.	576	646
Restructuring accrual, current portion.	1,769	2,208
Short-term debt	2,376	2,178
Total current liabilities	20,121	24,671
Capital lease obligations, less current portion	132	194
Restructuring accrual, less current portion	4,268	4,651
Long-term debt.	1,980	2,575
Deferred rent	200	187
Total liabilities	26,701	32,278
Stockholders' equity		
Common stock.	41	40
Additional paid-in capital.	248,311	250,485
Notes receivable from stockholders.	(7,567)	(7,795)
Unearned stock-based compensation	(8,453)	(11,732)
Accumulated other comprehensive income (loss) . . .	(89)	95
Accumulated deficit	(226,333)	(215,750)
Total stockholders' equity.	5,910	15,343
Total liabilities and stockholders' equity. . .	$ 32,611	$ 47,621

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

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

	THREE MONTHS SEPTEMBER
	2001
	(unaudit
Revenues:	
Solutions	$ 2,341
Subscriptions	1,396
Total revenues	3,737
Cost of revenues:	
Solutions	1,415
Subscriptions	450
Stock based charges	(135)
Total cost of revenues	1,730
Gross profit	2,007
Operating expenses:	
Sales and marketing:	
Other sales and marketing	4,574
Stock based charges	(95)
Research and development:	
Other research and development	3,515
Stock based charges	157
General and administrative:	
Other general and administrative	2,289
Stock based charges	1,326
Amortization of goodwill and other intangible assets	401
Restructuring charges	693
Total operating expenses	12,860
Operating loss	(10,853)
Other income, net	270
Net loss	(10,583)
Beneficial conversion feature of Series I redeemable convertible preferred stock	-
Net loss attributable to common stockholders	$ (10,583)
Net loss per common share -- basic and diluted	$ (0.29)
Shares used in net loss per common share calculation -- basic and diluted	36,905

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

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

	THREE MONTHS END SEPTEMBER 30,	
	2001	20
	(unaudited)	
Cash flows from operating activities:		
Net loss	$ (10,583)	$(25
Adjustments to reconcile net loss to net cash used in operating activities:		
Loss on disposal of fixed assets	-	
Allowance for doubtful accounts	545	
Depreciation and amortization - fixed assets	932	
Amortization of goodwill and other intangible assets	401	2
Non cash restructuring charges	103	
Accrued interest	-	
Stock-based charges	1,253	8
Changes in assets and liabilities:		
Accounts receivable	2,281	(2
Prepaid expenses and other current assets	(68)	
Deposits and other assets	29	
Accounts payable	(1,448)	
Accrued liabilities	(895)	
Restructuring accrual	(822)	
Deferred revenues	(1,994)	(1
NET CASH USED IN OPERATING ACTIVITIES	(10,266)	(17
Cash flows from investing activities:		
Purchase of short-term investments	(521)	(4
Maturities of short-term investments	2,500	
Purchases of property and equipment	(192)	(3
Proceeds from sale of property and equipment	-	
Purchases of intangibles	-	
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	1,787	(8
Cash flows from financing activities:		
Payments under capital lease obligations	(132)	
Repayment of long-term debt	(396)	
Proceeds from initial public offering	-	46
Proceeds from issuance of preferred stock, net of issuance costs	-	12
Proceeds from exercise of common stock options	-	
Proceeds from exercise of common stock warrants	-	
Proceeds from employee stock purchase plan	80	

Proceeds from payment on note receivable	-	
Payments on repurchase of common stock	-	
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	(448)	60
Effect of exchange rate changes on cash and cash equivalents	(120)	
Increase (decrease) in cash and cash equivalents	(9,047)	33
Cash and cash equivalents at beginning of period	19,914	18
Cash and cash equivalents at end of period	$ 10,867	$ 52

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

EVOLVE SOFTWARE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

THE COMPANY

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

BASIS OF PRESENTATION

The accompanying unaudited consolidated condensed financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Articles 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principals for complete financial statements. All adjustments (including adjustments of a normal recurring nature) considered necessary for a fair presentation have been included. Operating results for the three-month period ended September 30, 2001, are not necessarily indicative of the results that may be expected for the year ending June 30, 2002. For further information, refer to the financial statements and notes thereto included in the Company's Annual Report on Form 10K/A.

PRINCIPLES OF CONSOLIDATION

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

USE OF ESTIMATES

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

REVENUE RECOGNITION

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

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

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

The Company's customer agreements typically include arrangements for maintenance services to be provided by the Company. Generally, the Company has vendor specific objective evidence of fair value for the maintenance element of software arrangements based on the renewal rates for maintenance in future years as specified in the contracts. In those cases where first year maintenance revenue is included in the license fee, the Company defers the fair value of the first year maintenance revenue at the outset of the arrangement and recognizes it ratably over the period during which the maintenance is to be provided, which normally commences on the date the software is delivered.

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Historically, the Company did not have vendor specific objective evidence of fair value for services specified in certain software arrangements, as the services were never sold separately. Accordingly, the remaining software revenue allocated to such software licenses and services was recognized ratably on a straight-line basis over the period during which the services were provided, which was generally between six and nine months. In October 2000 the Company established vendor specific objective evidence of fair value for certain services. For these contracts, which involve significant implementation or other services which are essential to the functionality of the software and which are reasonably estimable, the license and services revenue is recognized over the period of each implementation, primarily using the percentage-of-completion method. Labor hours incurred are used as the measure of progress towards completion. Revenue for these arrangements is classified as Solutions revenue. A provision for estimated losses on engagements is made in the period in which the loss becomes probable and can be reasonably estimated. In cases where a sale of a license does not include implementation services (e.g., a sale of additional seats or a sale of product to be implemented by a third party), revenue is recorded upon delivery with an appropriate deferral for maintenance services, if applicable, provided all of the other relevant conditions have been met.

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

License revenue includes product licenses to companies from which the Company has purchased products and services under separate arrangements executed within a short period of time ("reciprocal arrangements"). Products and services purchased in reciprocal arrangements include: 1) software licensed for internal use, 2) software licensed for resale or incorporation into the Company's products; and 3) development or implementation services. For reciprocal arrangements, the Company considers Accounting Principles Boards or APB No. 29, "Accounting for Nonmonetary Transactions," and Emerging Issues Task Force or EITF, Issue No. 86-29, "Nonmonetary Transactions: Magnitude of Boot and Exceptions to the Use of Fair Value, Interpretation of Accounting Principles Board No. 29, Accounting for Nonmonetary Transactions" to determine whether the arrangement is a monetary or nonmonetary transaction. In determining these fair values, the Company considers the recent history of cash sales of the same products or services in similar sized transactions. Revenues recognized under reciprocal arrangements were $434,000 and $695,905 for the fiscal quarters ended September 30, 2001 and 2000, respectively.

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

COMPREHENSIVE INCOME (LOSS)

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

	THREE MONTHS ENDED SEPTEMBER 30, 2001	THREE MONTHS ENDED SEPTEMBER 30, 2000
Net loss	$ (10,583)	$ (25,275)
Foreign currency translation adjustment	(184)	(3)
Comprehensive loss	$ (10,767)	$ (25,278)

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SEGMENT INFORMATION

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

RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141 "Business Combinations" and SFAS No. 142 "Goodwill and Other Intangible Assets." SFAS No. 141 requires business combinations initiated after June 30, 2001, to be accounted for using the purchase method of accounting, and broadens the criteria for recording intangible assets separately from goodwill. Recorded goodwill and intangibles will be evaluated against these new criteria and may result in certain intangibles being subsumed into goodwill, or alternatively, amounts initially recorded as goodwill may be separately identified and recognized apart from goodwill. SFAS No. 142 requires the use of a non-amortization approach to account for purchased goodwill and certain intangibles. Under a non-amortization approach, goodwill and certain intangibles will not be amortized into results of operations, but instead would be reviewed for impairment and written-down and charged to results of operations only in the periods in which the recorded value of goodwill and certain intangibles is more than its fair value. Evolve will continue to amortize goodwill and purchased intangible assets acquired prior to June 30, 2001, until it adopts SFAS No. 142. For business combinations initiated after June 30, 2001, Evolve will follow the non-amortization method under SFAS No. 142. Evolve is currently assessing SFAS No. 141 and 142 and has not determined the impact on Evolve's consolidated financial statements.

In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations," which is effective for fiscal years beginning after June 15, 2002. This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 requires, among other things, that the retirement obligations be recognized when they are incurred and displayed as liabilities on the balance sheet. In addition, the asset's retirement cost is to be capitalized as part of the asset's carrying amount and subsequently allocated to expense over the asset's useful life. The Company believes that the adoption of SFAS No. 143 will not have a significant impact on its financial statements.

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

NOTE 2. ACQUISITIONS

On June 29, 2001, Evolve acquired certain assets of Vivant! Corporation

("Vivant"). The total acquisition cost was approximately $3.1 million primarily comprised of $910,000 in cash, 1,553,254 shares of the Company's common stock valued at $1.6 million, a future stock commitment valued at a minimum of $525,000 and $137,000 for transaction related expenses. With the assistance of an independent valuation, the Company recorded approximately $2.2 million in developed technology, $717,000 in goodwill and $187,000 in acquired workforce upon this acquisition which was accounted for as a purchase. The Company subsequently issued 663,495 shares to Vivant in September 2001 pursuant to the terms of the acquisition agreement. The number of shares issued to Vivant at the closing of the acquisition is subject to adjustment (by issuance of additional shares or redemption of existing shares) based on the market value of Evolve's common stock as of the time the registration of such shares becomes effective. In addition, Evolve has agreed to issue to Vivant additional shares of its common stock with a value of no less than $525,000 and no more than $4,425,000 at specified times based on receipts from the sale of Vivant's products for the shorter of twenty-four months from the date of the agreement or eighteen months from the Company's first customer contract that incorporates Vivant technology. The Company is still refining its purchase price allocation, which may result in adjustments in future periods. However, the asset acquisition agreement governing the purchase of the Vivant assets limits the aggregate number of shares of common stock to be issued by the Company to not exceed 7,661,097 shares. The results of Vivant's operations have been included in the consolidated financial statements since the date of acquisition.

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

	THREE MONTHS ENDED SEPTEMBER 30,	
	2001	2000
Revenues	$ 3,737	$ 6,959
Net loss	(10,583)	(34,890)
Basic and diluted net loss per share	$ (0.29)	$ (1.52)

NOTE 3. STOCK-BASED CHARGES

The Company incurred stock-based compensation in connection with stock option grants and sales of restricted stock to employees at exercise or sales prices below the deemed fair market value of its common stock for accounting purposes. The cumulative difference between the deemed fair value of the underlying stock at the date the options were granted and the exercise price of the granted options was $40.3 million as of August 9, 2000, the Company's IPO date. This amount is being amortized, using the accelerated method of FASB Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable or Award Plans," over the four-year vesting period of the granted options. Based on the unearned stock based compensation balance at September 30, 2001, the Company's results from operations will include stock-based compensation expense, at a minimum, through 2004. The Company recorded stock-based charges of $1.3 million and $9.0 million for the three months ended September 30, 2001, and September 30, 2000, respectively.

In connection with the termination of employment of certain executive officers in fiscal 2001, the Company entered into arrangements with those executive officers to provide consulting services. For accounting purposes, this was deemed to be a change in status of the employee and resulted in a new measurement date for the amended equity awards in accordance with FIN No. 44, "Accounting for Certain Transactions Involving Stock Compensation." In addition, for other executive officers of Evolve whose employment was terminated in fiscal 2001 and where those officers had purchased restricted stock with full recourse notes, the Company agreed as part of their termination settlement to allow them to sell back to the Company their restricted shares in exchange for cancellation of the notes. Accordingly, these notes are accounted for as non-recourse notes on a variable basis such that the charge/credit arising from these notes will fluctuate from period to period based on the Company's stock price. The revaluation charge for the notes subject to remeasurement was not significant for the quarter ended September 30, 2001. The financial impact of these arrangements is included within stock-based compensation expense, which has been allocated to the appropriate functional categories within the Statement of Operations.

NOTE 4. LONG-TERM DEBT

In January 2001 the Company entered into a credit arrangement providing a line-of-credit of $7.5 million and a $7.5 million term loan credit facility with interest accruing at the bank's prime rate plus 0.75% and 1.00%, respectively. At September 30, 2001, these rates were 7.25% and 7.5%, respectively. As of September 30, 2001, the Company had utilized $4.8 million of the term loan credit facility and had repaid $396,000. The loan will be fully repaid by July 1, 2003. Both the line-of-credit and the term loan credit facility are collateralized by all of the Company's assets, including intellectual property, except for previously leased equipment. The line-of-credit also includes a $5.0 million sublimit to secure commercial and/or standby letters-of-credit of which $2.9 million has been utilized to support letters-of-credit issued to the landlord of the Company's Emeryville facility. Any advances on the line-of-credit mature one year from the loan documents with interest due monthly. Advances on the term loan credit facility are due twenty-eight months from the advance with interest-only payments for the first four months and then equal payments of interest and principal amortized over the remaining twenty-four months. The Company is required to maintain certain financial ratios as part of the loan covenants.

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In September 2001, the Company entered into a commitment letter to amend the Loan and Security Agreement, and thereafter signed an amended and restated Loan and Security Agreement on November 13, 2001, to restructure the excess credit facilities, to obtain a waiver of certain defaults under the credit arrangement and to reduce the line-of-credit to $3 million and the term loan credit facility to $4.4 million. According to the bank, the Company had been in violation of bank covenants to maintain minimum revenue levels for the months of April through September 2001. In connection with the loan amendment, the bank waived these covenant violations on September 26, 2001, and approved new financial covenants for the periods commencing October 1, 2001. Under the new covenants, the Company will be required to: (1) maintain at all times a minimum bank liquidity ratio of 1.50 to 1.00, reducing to a ratio of 1.25 to 1.00 on January 31, 2002, (the cash component of this ratio is required to be held at the bank); (2) beginning with the month ending December 31, 2001, maintain on a monthly basis the greater of (a) a minimum company liquidity ratio of 1.75 to 1.00 or (b) $14,000,000 in unrestricted cash (unrestricted cash will include any restricted cash held by the bank) reducing to $8,000,000 on January 31, 2002; (3) beginning with the month ending December 31, 2001, not exceed a leverage maximum of 2.25 to 1.00; and (4) meet a milestone covenant of obtaining at least $10,000,000 in new equity from investors acceptable to the bank by October 15, 2001 (this milestone was met).

NOTE 5. CONTINGENCIES

From time to time, the Company may become involved in litigation relating to claims arising from the ordinary course of business. For example, one of the Company's early customers filed an action in the federal district court in Massachusetts and several other customers filed actions in either state or federal court in California, each alleging a variety of claims including that the software and services purchased from the Company did not satisfy certain contractual obligations or, in two cases, that the Company engaged in practices that they allege were unfair or misrepresentative. Certain of these claims were filed as counterclaims to actions instituted by the Company to collect outstanding receivables. All of these claims are still in the early stages of litigation, and it is, therefore, not possible to estimate the outcome of these contingencies.

In November 2001, a complaint seeking class action status was filed in the United States District Court for the Southern District of New York. The complaint is purportedly brought on behalf of all persons who purchased the Company's common stock from August 4, 2000, through December 6, 2000. The complaint names as defendants some of the Company's former and current officers, and several investment banking firms that served as managing underwriters of the Company's initial public offering. As of the date of this report, neither the Company nor the individual defendants named had been served with the complaint. Among other things, the complaint alleges liability under the Securities Act of 1933 and the Securities Exchange Act of 1934, on the grounds that the registration statement for the Company's initial public offering did not disclose that: (1) the underwriters had allegedly agreed to allow certain of their customers to purchase shares in the offering in exchange for alleged excess commissions paid to the underwriters; and (2) the underwriters had allegedly arranged for certain of their customers to purchase additional shares in the aftermarket at pre-determined prices under alleged arrangements to manipulate the price of the stock in aftermarket trading. The Company is aware that similar allegations have been made in numerous other lawsuits challenging initial public offerings conducted in 1998, 1999 and 2000. No specific amount of damages is claimed in the complaint involving the initial public offering. The Company intends to contest the claims vigorously. The Company is unable, at this time, to determine whether the outcome of the litigation will have a material impact on our results of operations or financial condition in any future period.

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

NOTE 6. RESTRUCTURING CHARGES

During the quarter ended September 30, 2001, the Company recorded a restructuring charge of $693,000 related to actions taken to reduce costs and to strengthen the Company's position to execute its strategy. The restructuring charge included $590,000 of severance related costs, which resulted from the involuntary termination of 49 employees or 19% of the Company's workforce. These employees were primarily in the Company's United States operations. As a result of the headcount reduction, the Company recorded $103,000 for the disposal of excess computer hardware and telecommunications equipment. These charges were in addition to the $9.7 million in restructuring charges that were recorded in the quarter ended June 30, 2001. A rollforward of the restructuring-related liabilities follows.

(in thousands)	SEVERANCE AND RELATED CHARGES	ACCRUAL OF LEASE COMMITMENTS	FIXED ASSET WRITE-OFF	TOTALS
Restructuring charges	$ 1,597	$ 6,433	$ 1,694	$ 9,724
Amount paid	(817)	(354)	-	(1,171)
Non-cash charges	-	-	(1,694)	(1,694)
Accrued liabilities at June 30, 2001	780	6,079	-	6,859
Restructuring charges	590	-	103	693
Amount paid	(1,007)	(405)	-	(1,412)
Non-cash charges	-	-	(103)	(103)
Accrued liabilities at September 30, 2001	$ 363	$ 5,674	$ -	$ 6,037
Short-term	$ 363	$ 1,406	$ -	$ 1,769
Long-term	$ -	$ 4,268	$ -	$ 4,268

NOTE 7. NET LOSS PER SHARE

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

	THREE MONTHS ENDED SEPTEMBER 30,	
	2001	2000
Numerator:		
Net loss	$(10,583)	$(25,275)
Beneficial conversion feature of Series I redeemable convertible preferred stock	-	(5,977)
Net loss attributable to common stockholders	$(10,583)	$(31,252)
Denominator:		
Weighted average common shares	40,052	26,244
Weighted average unvested common shares subject to repurchase	(3,147)	(5,455)
Shares used in computing basic and diluted net loss per share	36,905	20,789

At September 30, 2001 and 2000, options to purchase 4,762,007 and 1,702,227 shares of common stock were outstanding with a weighted-average exercise price of $3.51 and $6.20, respectively. These common stock equivalents have been excluded from the computation of diluted net loss per share because the effect would have been anti-dilutive. The weighted-average purchase price of stock subject to repurchase was $2.29 and $2.22 as of September 30, 2001 and 2000, respectively.

NOTE 8. SUBSEQUENT EVENTS

On September 23, 2001, the Company signed a Series A Preferred Stock Purchase Agreement with new and existing investors for a private placement of 1.3 million shares of convertible preferred stock at $10.00 per share (convertible into common stock at a rate of $.50 per share) for total proceeds of $13 million as

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well as warrants to purchase 6.5 million shares of common stock at $1.00 per share. In addition, the Company issued warrants to purchase 1.3 million additional shares of convertible preferred stock for additional potential proceeds of $13 million, which will also include, upon exercise, warrants to purchase an additional 6.5 million shares of common stock at $1.00 per share. Closing of the arrangement and receipt of $13 million occurred on October 9, 2001.

In October 2001 the Company negotiated with its landlord for an amendment to the original Emeryville lease agreement to relieve the Company from its payment obligations for the excess premises and increase the payment obligations for the occupied facilities. As a result of this agreement, the Company anticipates reversing approximately $2.1 million of the total $6.4 million facilities restructuring accrual recorded in the quarter ended June 30, 2001.

Since September 30, 2001, there have been several changes in the Company's executive management team. John P. Bantleman, the Company's former President and Chief Executive Officer, James J. Bozzini, the Company's former Chief Operating Officer, and Joseph A. Fuca, the Company's former Vice President, North American Sales, all left the Company in October 2001; David Hsieh, formerly Vice President, Marketing, left the Company in November 2001. In October 2001, the Company appointed Lin Johnstone as Interim Chief Executive Officer, and announced that it had initiated an executive search for a permanent Chief Executive Officer.

In November 2001, the Company initiated a workforce reduction intended to further reduce operating expenses and to consolidate the Company's employment focus to North America. Associated with this restructuring, the Company closed its India development center. The Company's worldwide headcount will be approximately 140 employees after the reduction.

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

You should read the following discussion in conjunction with the interim unaudited condensed consolidated financial statements and related notes included in this report, and with Management's Discussion and Analysis of Financial Condition and Results of Operations and related financial information contained in our Annual Report on Form 10-K/A for the fiscal year ended June 30, 2001.

Except for historical information, this report may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements involve risks and uncertainties, including, among other things, statements regarding our anticipated costs and expenses. Our actual results may differ significantly from those projected in the forward-looking statements. Factors that might cause or contribute to these differences include, but are not limited to, those discussed in the section below entitled "Factors That May Affect Future Results of Operations." You should carefully review these risks as well as the discussion of risks and uncertainties contained in our Annual Report on Form 10-K/A under the caption "Business-Factors That May Affect Future Results." You are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to publicly release any revisions to the forward-looking statements or reflect subsequent events or circumstances after the date of this document.

OVERVIEW

Evolve is a leading provider of integrated Internet-based strategic workforce optimization software for automating people-driven service organizations like professional services firms and corporate information technology ("IT") groups. Our Evolve 4 software suite integrates and streamlines the core processes that are critical to services-oriented organizations, which center around managing project portfolios, project opportunities, professional resources (including contract workers) and service delivery. Our solution combines the efficiency gains of automating core business processes with the benefits of on-line intercompany collaboration, creating a Strategic Workforce Optimization Platform for a variety of project-driven services organizations.

We have licensed our solution to over one hundred customers who have collectively purchased it to manage over 82,000 professionals. Our customers include professional services firms such as EDS and Icon Media Lab, high tech services organizations at companies such as Sun Microsystems, Novell and Autodesk and Corporate IT organizations in companies such as CSFBdirect and Fleet Financial.

Evolve was founded in February 1995. From our inception through December 1998 our activities, funded by the venture capital we raised, consisted primarily of building our business infrastructure, recruiting personnel and developing our software and service offerings. Our Evolve solution was first made commercially available in March 1999. We recognized our first revenues from the Evolve solution during the quarter ended March 31, 1999. We have incurred substantial losses since inception and we anticipate that we will continue to incur operating losses as we make the investments necessary to run our business. Our accumulated deficit at September 30, 2001, was $226.3 million.

Beginning in the fourth quarter of fiscal 2001, in response to market conditions, we reduced our workforce, restructured our organization and took other measures to reduce operating expenses. As a result, our headcount was reduced to 201 employees as of September 30, 2001, from 365 employees as of March 31, 2001.

In August 2000 we completed an initial public offering of 5,750,000 shares of our common stock, resulting in proceeds of approximately $46.5 million, net of offering costs.

On September 23, 2001, we signed a Series A Preferred Stock Purchase Agreement with new and existing investors for a private placement of 1.3 million shares of convertible preferred stock at $10.00 per share for total proceeds of $13 million as well as warrants to purchase 6.5 million shares of common stock at $1.00 per share. In addition, we issued warrants to purchase 1.3 million additional shares of convertible preferred stock for additional potential proceeds of $13 million, which will also include, upon exercise, warrants to purchase an additional 6.5 million shares of common stock at $1.00 per share. Closing of the arrangement and receipt of $13 million occurred on October 9, 2001.

RESULTS OF OPERATIONS

REVENUES

Total revenues were $3.7 million for the three months ended September 30, 2001, compared with revenues of $7.0 million for the comparable 2000 period, representing a 46% decrease in total revenues. For the quarter ended September 30, 2001, sales to two customers accounted for 37% and 22% of total revenues. For the quarter ended September 30, 2000, sales to one customer accounted for 11% of total revenues.

The decrease in revenues is attributable to our effort to diversify our client base to include global services companies, services divisions of technology companies and Corporate IT organizations in Global 2000 companies. These types of companies generally have extended sales cycles. Additionally, sales across all customer segments have been impacted by the recent downturn in the economy and subsequent reductions in corporate IT spending.

We classify our revenue as either Solutions revenue or Subscriptions revenue. Solutions revenue consists principally of software licenses and implementation services while Subscriptions revenue consists principally of application service provider ("ASP") fees and maintenance subscriptions. For the three months ended September 30, 2001, Solutions revenues and Subscriptions revenue were $2.3 million, or 63% of total revenues, and $1.4 million, or 37% of total revenues, respectively. For the three months ended September 30, 2000, Solutions revenues and Subscriptions revenues were $5.0 million, or 73% of total revenues, and $1.9 million, or 27% of total revenues, respectively.

COST OF REVENUES

Our cost of revenues includes the costs directly associated with our Solutions and Subscriptions revenues, including stock-based compensation. The cost of our Solutions revenues consists principally of payroll-related costs for employees and consultants involved in providing services for implementation, training and consulting. The cost of our Solutions revenues also includes royalties due to third-parties for integrated third-party technology, and to a lesser extent, printing costs of product documentation, duplication costs for software media and shipping costs. Cost of Subscriptions revenues consists primarily of the payroll-related costs for employees involved in providing support services to customers under maintenance contracts as well as payroll costs for employees and consultants involved in providing services for implementation, training and consulting for our ASP customers. Cost of Subscriptions also includes hosting fees required to service our ASP customers.

Total cost of revenues, excluding stock-based compensation, was $1.9 million for the three months ended September 30, 2001, compared with $4.0 million for the three months ended September 30, 2000, representing a 53% decrease in cost of revenues. As a percentage of total revenues, total cost of revenues, excluding stock-based compensation, was 50% and 57% for the quarters ended September 30, 2001 and 2000, respectively.

Cost of Solutions revenues, excluding stock-based compensation, was $1.4 million and the cost of Subscriptions revenues was $450,000 for the three months ended September 30, 2001. Cost of Solutions revenues was $2.9 million and the cost of Subscriptions revenues was $1.1 million for the quarter ended September 30, 2000. As a percentage of Solutions revenues, cost of Solutions revenues was 60% and 58% for the quarters ended September 30, 2001 and 2000, respectively. As a percentage of Subscriptions revenues, cost of Subscriptions revenues was 32% and 55% for the quarters ended September 30, 2001 and 2000, respectively.

The decrease in cost of Solutions revenues was primarily attributable to the decreased costs associated with employees and third-party consultants involved in providing implementation, training and consulting services to our customer base. The number of employees in our services organization decreased by 78% from September 30, 2000, to September 30, 2001. The decrease in cost of Subscriptions revenues was primarily due to decreased payroll costs for employees and third-party consultants involved in providing support services to customers under maintenance and application subscription contracts. We are seeking to reduce our cost of Solutions revenues by having our customers engage third-parties to provide a substantial portion of services related to our applications.

OPERATING EXPENSES

SALES AND MARKETING. Sales and marketing expenses consist primarily of employee salaries, benefits, commissions and stock-based compensation, as well as the costs of advertising, public relations, website development, trade shows, seminars, promotional materials and other sales and marketing programs. Additionally, sales and marketing expenses include costs of service personnel that have not been treated as part of cost of revenues. Sales and marketing expenses, excluding stock-based compensation, decreased by 59% to $4.6 million

for the quarter ended September 30, 2001, from $11.0 million for the quarter ended September 30, 2000. The decrease in sales and marketing expenses resulted primarily from significant workforce reductions implemented during the quarters ended June 30, 2001, and September 30, 2001. The number of employees in our sales and marketing organization decreased by 49% from September 30, 2000, to September 30, 2001. We expect that the level of sales and marketing expenses will continue to decline in the next quarter as we experience the full effects of cost cutting measures taken during the quarter ended September 30, 2001.

RESEARCH AND DEVELOPMENT. Research and development expenses consist primarily of personnel and related costs, including stock-based compensation, associated with our product development efforts, including fees paid to third-parties for engineering consulting services. Research and development expenses, excluding stock-based compensation, decreased 8% to $3.5 million for the three months ended September 30, 2001, from $3.8 million for the three months ended September 30, 2000. The decrease in research and development expenses related primarily to a decreased reliance on third-party consultants that we previously utilized to accelerate the delivery of Evolve 4 and other development projects. During the quarter ended March 31, 2001, we opened a software development center in India that became fully operational during the quarter ended June 30, 2001. As a result of the India operation, the number of employees in our research and development organization increased by 30% from September 30, 2000, to September 30, 2001. Because of the lower costs of operating in India, the additional cost of India was offset by the decline in third-party consultants. We expect that the absolute dollar amount of research and development expenses will not increase in the next quarter.

GENERAL AND ADMINISTRATIVE. General and administrative expenses consist primarily of employee salaries and expenses, including stock-based compensation related to executive, finance and administrative personnel, bad debt expense, and professional service fees. General and administrative expenses, excluding stock-based compensation, decreased 9% to $2.3 million for the three months ended September 30, 2001, from $2.5 million for the three months ended September 30, 2000. The decrease in general and administrative expenses resulted primarily from our workforce reductions, offset by an increase in bad debt expense. The number of employees in our general and administrative organization decreased by 45% from September 30, 2000, to September 30, 2001.

We increased our bad debt allowance by $545,000 during the quarter ended September 30, 2001. This increase resulted from the impact of the worsening general economic situation on selected customers, in particular e-business consultancies that focused on web development and e-commerce integration. Many of these customers have encountered difficulties in securing additional financing to meet their obligations and have sought to limit expenditures to conserve their cash balances. We continue to monitor our customers' ability to pay throughout the term of the arrangement and, in the face of the weakening economy, will adjust the provision for bad debt allowance or defer revenue recognition, as appropriate.

We expect that general and administrative expenses will remain stable in the next quarter.

AMORTIZATION OF STOCK-BASED CHARGES. We incurred stock-based compensation in connection with stock option grants and sales of restricted stock to our employees at exercise or sales prices below the deemed fair market value of our common stock for accounting purposes and as a result of amending certain stockholder loans and accelerated vesting rights granted to terminated executives. Based on the remaining balances at September 30, 2001, our results from operations will include stock-based compensation expense, at a minimum, through 2004. We recorded stock-based charges of $1.3 million and $9.0 million for the three months ended September 30, 2001, and September 30, 2000, respectively. Stock-based charges are amortized on an accelerated basis and the decrease in stock-based amortization resulted primarily from the resulting decline in the cost over time. In addition, employee terminations in the current and prior quarters reduced current quarter charges and also reversed some amortization previously taken on an accelerated basis. Amortization of stock-based compensation consisted of the following (in thousands):

	THREE MONTHS ENDED SEPTEMBER 30, 2001	THREE MONTHS ENDED SEPTEMBER 30, 2000
Cost of revenues:		
Solutions	$ (135)	$ 744
Operating expenses:		
Sales and marketing	(95)	2,620
Research and development	157	1,523
General and administrative	1,326	4,063
Total	$ 1,253	$ 8,950

AMORTIZATION OF GOODWILL AND OTHER INTANGIBLE ASSETS. In connection with the acquisition of Vivant! Corporation on June 29, 2001, and, with the assistance of an independent valuation, we recorded $2.2 million for developed technology, $717,000 for goodwill and $187,000 for acquired workforce. Additionally, in connection with the acquisition of InfoWide, Inc., on March 31, 2000, we recorded $32.6 million in goodwill, purchased technology and other intangible assets including in-process technology of $3.1 million. During the quarter ended June 30, 2001, our goodwill and other intangibles were substantially reduced because of the write-off of $18.1 million resulting from the impairment of all the intangible assets that remained from the InfoWide acquisition. As a result of the acquisition of Vivant and the write-off of InfoWide, amortization of goodwill and other intangible assets declined to $401,000 for the quarter ended September 30, 2001, from $2.7 million for the three months ended September 30, 2000. We amortized goodwill and other intangible assets over periods not exceeding thirty-six months.

RESTRUCTURING COSTS. In August 2001 we continued the cost control measures commenced in April 2001 to streamline operations and reduce costs, and further reduced our headcount by 49 employees. As a result of the workforce reduction, we recorded a charge of $693,000, which consisted of severance related costs of $590,000 and a write-off of excess computer hardware and telecommunications equipment, related to the workforce reduction, of $103,000.

OTHER INCOME, NET. Other income, net was $270,000 and $795,000 at September 30, 2001 and 2000, respectively. The 66% decrease resulted primarily from a decline in our cash balances and bank interest rates which resulted in a $626,000 interest income reduction. The decline in interest income was partially offset by a $121,000 increase in foreign exchange translation gain resulting primarily from the strengthening of the British pound against the United States dollar.

BENEFICIAL CONVERSION OF PREFERRED STOCK. We recorded a dividend charge of $6.0 million for the quarter ended September 30, 2000, in respect of a beneficial conversion feature associated with the sale of approximately 2,000,000 shares of our Series I Preferred Stock in fiscal 2001. The deemed fair value for accounting purposes was $9.00 per share.

LIQUIDITY AND CAPITAL RESOURCES

For the quarter ended September 30, 2001, net cash used in operating activities was $10.3 million resulting principally from a net loss of $10.6 million offset by amortization and depreciation of $1.5 million, stock-based charges of $1.3 million and a net decrease in assets and liabilities of $2.9 million. For the quarter ended September 30, 2000, net cash used in operating activities was $17.8 million resulting principally from a net loss of $25.3 million offset by amortization and depreciation of $3.5 million and stock-based charges of $9.0 million and a net decrease in assets and liabilities of $5.0 million.

Net cash provided by investing activities for the three months ended September 30, 2001, was $1.8 million compared with net cash used by investing activities of $8.8 million for the same period in fiscal 2000. Cash provided by investing activities for the three months ended September 30, 2001, resulted primarily from the net sale of short-term investments of $2.5 million partially offset by the purchase of property and equipment of $192,000. Cash used by investing activities for the three months ended September 30, 2000, resulted primarily from the purchase of $4.9 million of short-term investments and purchases of property and equipment of $3.2 million.

Net cash used in financing activities for the three months ended September 30, 2001, was $448,000 compared with net cash provided by financing activities of $60 million for the same prior year period. Cash used in financing activities for the three months ended September 30, 2001, resulted from principal payments

on our bank credit facility of $396,000 and payments of capital lease obligations of $132,000 partially offset by proceeds from our employee stock purchase plan of $80,000. Net cash provided by financing activities for the three months ended September 30, 2000, resulted principally from the net proceeds of our initial public offering of $46.5 million and preferred and common stock issuances of $13.9 million.

At September 30, 2001, we had cash, cash equivalents and investments of $11.7 million. We believe that our current cash and investment balances, cash flow from operations and funds from our sale of Series A Preferred Stock in October 2001 will be sufficient to meet our working capital and capital expenditure requirements for at least the next twelve months.

In January 2001 we entered into a credit arrangement providing a line-of-credit of $7.5 million and a $7.5 million term loan credit facility with interest accruing at the rate of the bank's prime rate plus 0.75% and 1.00%, respectively. At September 30, 2001, these rates were 7.25% and 7.5%, respectively. As of September 30, 2001, we had utilized $4.8 million of the term loan credit facility and had repaid $396,000. The loan will be fully repaid by July 1, 2003. Both the line-of-credit and the term loan credit facility are collateralized by all of our assets, including intellectual property, except for previously leased equipment. The line-of-credit also includes a $5.0 million sublimit to secure commercial and/or standby letters-of-credit of which $2.9 million has been utilized to support letters-of-credit issued to the landlord of our Emeryville facility. Any advances on the line-of-credit mature one year from the loan documents with interest due monthly. Advances on the term loan credit facility are due twenty-eight months from the advance with interest only payments for the first four months and then equal payments of interest and principal amortized over the remaining twenty-four months. We are required to maintain certain financial ratios as part of the loan covenants.

In September 2001, we entered into a commitment letter to amend the Loan and Security Agreement, and thereafter signed an amended and restated Loan and Security Agreement on November 13, 2001, to restructure the excess credit facilities, to obtain a waiver of certain defaults under the credit arrangement and to reduce the line-of-credit to $3 million and the term loan credit facility to $4.4 million. According to the bank, we had been in violation of bank covenants to maintain minimum revenue levels for the months of April through September 2001. In connection with the loan amendment, the bank waived these covenant violations on September 26, 2001, and approved new financial covenants for the periods commencing October 1, 2001. Under the new covenants, we will be required to: (1) maintain at all times a minimum bank liquidity ratio of 1.50 to 1.00, reducing to a ratio of 1.25 to 1.00 on January 31, 2002 (the cash component of this ratio is required to be held at the bank); (2) beginning with the month ending December 31, 2001, maintain on a monthly basis equal to the greater of (a) a minimum company liquidity ratio of 1.75 to 1.00 or (b) $14,000,000 in unrestricted cash (unrestricted cash will include any restricted cash held by the bank) reducing to $8,000,000 on January 31, 2002 (3) beginning with the month ending December 31, 2001, not exceed a leverage maximum of 2.25 to 1.00; and (4) meet a milestone covenant of obtaining at least $10,000,000 in new equity from investors acceptable to the bank by October 15, 2001 (this milestone was met).

FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS

OUR BUSINESS IS DIFFICULT TO EVALUATE BECAUSE OUR OPERATING HISTORY IS LIMITED.

It is difficult to evaluate our business and our prospects because our revenue and income potential are unproven. We commenced recognizing sales revenues in March of 1999. Because of our limited operating history, there may not be an adequate basis for forecasts of future operating results, and we have only limited insight into the trends that may emerge in our business and affect our financial performance.

WE HAVE INCURRED LOSSES SINCE INCEPTION, AND WE MAY NOT BE ABLE TO ACHIEVE PROFITABILITY.

We have incurred net losses and losses from operations since our inception in

1995, and we may not be able to achieve profitability in the future. As of September 30, 2001, we had an accumulated deficit of approximately $226.3 million. Since inception, we have funded our business primarily from the sale of our stock and by borrowing funds, not from cash generated by our business. Despite recent cost reductions, we expect to continue to incur significant sales and marketing, research and development, and general and administrative expenses. As is the case with many enterprise software companies, we have experienced a sequential quarterly decline in revenue for the quarter ending September 30, 2001, and may experience a further decline in the current quarter. As a result, we expect to experience continued losses and negative cash flows from operations. If we do achieve profitability, we may not be able to sustain or increase profitability on a quarterly or annual basis in the future.

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OUR FUTURE OPERATING RESULTS MAY NOT FOLLOW PAST TRENDS DUE TO MANY FACTORS, AND ANY OF THESE COULD CAUSE OUR STOCK PRICE TO FALL.

We believe that year-over-year comparisons of our operating results are not a good indication of future performance. Although our operating results have generally improved from year to year in the recent past, our future operating results may not follow past trends. It is likely that in some future years our operating results may be below the expectations of public market analysts and investors due to factors beyond our control and, as a result, the price of our common stock may fall.

Factors that may cause our future operating results to be below expectations and cause our stock price to fall include:

- the lack of demand for and acceptance of our products, product enhancements and services; for instance, as we expand our target customer focus beyond the information technology service consultancies and into internal information technology of corporate customers as well as into overseas markets, we may encounter increased resistance to adoption of our business process automation solutions;
- unexpected changes in the development, introduction, timing and competitive pricing of our products and services or those of our competitors;
- any inability to expand our direct sales force and indirect marketing channels both domestically and internationally;
- difficulties in recruiting and retaining key personnel;
- unforeseen reductions or reallocations of our customers' information technology infrastructure budgets; and
- any delays or unforeseen costs incurred in integrating technologies and businesses we may acquire.

We plan to aggressively and prudently manage our operating expenses with a focus on our research and development organization and our direct sales group. Our operating expenses are based on our expectations of future revenues and are relatively fixed in the short-term. If revenues fall below our expectations in any quarter, and we are not able to quickly reduce our spending in response, our operating results for that quarter would be lower than expected, and our stock price may fall.

WE MAY NEED SUBSTANTIAL ADDITIONAL CAPITAL TO FUND CONTINUED BUSINESS OPERATIONS AT THEIR CURRENT LEVELS IN FISCAL 2002 AND 2003 AND SUCH FINANCING MAY NOT BE AVAILABLE ON FAVORABLE TERMS, IF AT ALL.

We require substantial amounts of capital to fund our business operations. The rate at which our capital is utilized is affected by the level of our fixed expenses (including employee related expenses and expenses relating to real estate) and variable expenses. Substantial capital has been used to fund our operating losses. Since inception, we have experienced negative cash flow from operations and expect to experience significant negative cash flow from operations for the foreseeable future. In September 2001 we signed a definitive agreement for a private placement of our Series A Preferred Stock, which closed on October 9, 2001, and resulted in proceeds of $13 million. This financing, combined with the cost reductions we are undertaking and our existing credit facilities, is expected to be sufficient to meet our working capital requirements through the end of September 30, 2002. However, we may require additional capital prior to that time if one or more of the following occur:

- our revenues from the sale of our products may fall below our current expectations because of the current economic slowdown or otherwise.
- forecasted cash collections from customers may decline if some of our customers become insolvent or encounter financial difficulties.
- we may be unable to reduce our operating expenses as rapidly and as extensively as we hope. For instance, we may discover that we cannot reduce our employee headcount as rapidly as we would like in the event that we are unable to secure commitments from third parties to provide integration and support services to our customers in lieu of providing these services ourselves.
- we may be unable to comply with the financial and other covenants required under our existing credit facilities, and these credit facilities may be withdrawn as a result.
- we may encounter opportunities that we wish to pursue to acquire other businesses or technologies for cash consideration.

Accordingly, we may require or seek to raise additional capital during the 2002 or 2003 fiscal years. We cannot be certain that additional financing will be available on favorable terms, if at all.

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The investors participating in the private placement of our Series A Preferred Stock hold warrants to purchase additional shares of our Series A Preferred Stock and common stock which, if exercised in full, would result in additional proceeds to us of $26 million. However, these warrants are exercisable at prices in excess of the current market price of our common stock, and we cannot predict whether they will be exercised. We have not commenced any efforts to secure additional financing.

Further, the additional shares of our capital stock we may issue in any such financings may result in additional dilution, which may be substantial. If we need additional funds and cannot raise them on acceptable terms, we may not be able to continue our operations at the current level or at all.

WE MAY LOSE EXISTING CUSTOMERS, OR BE UNABLE TO ATTRACT NEW CUSTOMERS, IF WE DO NOT DEVELOP NEW PRODUCTS OR ENHANCE OUR EXISTING PRODUCTS.

If we are not able to maintain and improve our product-line and develop new products, we may lose existing customers or be unable to attract new customers. We may not be successful in developing and marketing product enhancements or new products on a timely or cost-effective basis. These products, if developed, may not achieve market acceptance.

A limited number of our customers expect us to develop product enhancements that may address their specific needs. For instance, we have shared with some of our customers our internal product roadmap that includes descriptions of new functional enhancements such as improved time and expense management for future releases of our software. If we fail to deliver these enhancements on a timely basis, we risk damaging our relationship with these customers. We have experienced delays in the past in releasing new products and product enhancements and may experience similar delays in the future. These delays or problems in the installation or implementation of our new releases may cause some of these customers to forego additional purchases of our products or to purchase those of our competitors.

WE MUST DIVERSIFY OUR CUSTOMER BASE IN ORDER TO ENHANCE OUR REVENUE AND MEET OUR GROWTH TARGETS.

We have historically derived a substantial percentage of our revenues from sales of our products and services to firms that provide technology-oriented consulting, design and integration services, including a number of firms specializing in Website design and e-commerce application development. Growth among these "e-business" consultancies has recently slowed dramatically, and many such firms have ceased operations or have encountered substantial difficulties in raising capital to fund their operations. In anticipation of these developments, we commenced a program to aggressively diversify our client base, targeting both established consulting services companies and in-house service departments of large corporations. While we have recorded a number of significant customer wins in these areas, we may in the future encounter significant challenges in further expanding our customer base. More established corporations are often more reluctant to implement innovative enterprise technologies such as ours, in part because they often have made substantial investments in legacy applications and information systems. We may also encounter extended sales cycles with such prospective customers, and slower rates of adoption of our solutions within their organizations. As we reduce our sales force headcount in order to reduce expenses, our sales capacity is diminished which may impact our ability to diversify our customer base. All of these factors may adversely affect our ability to sustain our revenue growth and attain profitable operations.

FINANCIAL DIFFICULTIES OF SOME OF OUR CUSTOMERS MAY ADVERSELY AFFECT OUR OPERATING RESULTS.

As discussed above, a substantial portion of our early customers were e-business consultancies focusing on Web development and e-commerce integration. As public valuations for many such businesses have declined substantially in recent months, some of our customers may encounter difficulties in securing additional financing to meet their obligations, or may seek to limit expenditures to conserve their cash resources. As a result, we may encounter difficulties in securing payment of certain customer obligations when due, and may be compelled to increase our bad debt reserves. Any difficulties encountered in collections from customers would also adversely affect our cash flow, and would adversely impact our operating results.

WE REDUCED OUR WORKFORCE DURING THE SECOND HALF OF THE PRIOR FISCAL YEAR, AND, IF WE FAIL TO MANAGE THIS REDUCTION IN WORKFORCE, OUR ABILITY TO GENERATE NEW REVENUE, ACHIEVE PROFITABILITY AND SATISFY OUR CUSTOMERS COULD BE HARMED.

We reduced our workforce during the second half of the prior fiscal year after growing significantly the first half of the year and in previous years. Any failure to manage this reduction in workforce could impede our ability to increase revenues and achieve profitability. We reduced our number of employees from 326 at June 30, 2000, to 201 as of September 30, 2001.

As we reduce our sales force headcount in order to reduce expenses, our sales capacity is reduced which may impact our revenue growth. As we reduce our service employee headcount, including our consulting services, training and technical support personnel, we may not be able to provide the same level of customer responsiveness or expertise, and customer satisfaction may be impacted as a result.

In order to manage our reduced workforce, we must:

- hire, train and integrate new personnel in response to attrition;
- continue to augment our management information systems;
- manage our sales and services operations, which are in several locations; and
- expand and improve our systems and facilities.

IF THE MARKET FOR PROCESS AUTOMATION SOLUTIONS FOR PROFESSIONAL SERVICES ORGANIZATIONS AND OTHER STRATEGIC WORKFORCES DOES NOT CONTINUE TO GROW, THE GROWTH OF OUR BUSINESS WILL NOT BE SUSTAINABLE.

The future growth and success of our business is contingent on growing acceptance of, and demand for, business process automation solutions for professional services organizations and other strategic workforces. Substantially all of our historical revenues have been attributable to the sale of automation solutions for professional services organizations. This is a relatively new enterprise application solution category, and it is uncertain whether major services organizations and service departments of major corporations will choose to adopt process automation systems. While we have devoted significant resources to promoting market awareness of our products and the problems our products address, we do not know whether these efforts will be sufficient to support significant growth in the market for process automation products. Accordingly, the market for our products may not continue to grow or, even if the market does grow in the immediate term, that growth may not be sustainable.

REDUCTIONS IN CAPITAL SPENDING BY CORPORATIONS COULD REDUCE DEMAND FOR OUR PRODUCTS.

Historically, corporations and other organizations have tended to reduce or defer major capital expenditures in response to slower economic growth or recession. Market analysts have observed a significant reduction in the growth of corporate spending on information technology projects in response to the current economic slowdown. To the extent that current economic uncertainty persists, some of the prospective customers in our current sales pipeline could choose to postpone or reduce orders for our products, or may delay implementing our solutions within their organizations. In addition, existing customers seeking to reduce capital expenditures may cancel or postpone plans to expand use of our products in additional operating divisions, or may defer plans to purchase additional modules of our solutions. Any of the foregoing would have an adverse impact on our revenues and our operating results, particularly if the current period of volatility in the stock market and the general economy is prolonged.

ANY INABILITY TO ATTRACT AND RETAIN SENIOR EXECUTIVE OFFICERS AND ADDITIONAL PERSONNEL COULD AFFECT OUR ABILITY TO SUCCESSFULLY GROW OUR BUSINESS.

We recently initiated searches for several executive officers including a permanent Chief Executive Officer and a Vice President of Engineering. Our future performance will depend, in significant measure, on our ability to recruit highly qualified individuals to serve in such positions and the ability of these new executives to work effectively with other members of our management team as well as key employees, customers and partners. In addition, if we are unable to hire and retain a sufficient number of qualified personnel, particularly in sales, marketing, research and development, services and support, our ability to grow our business could be affected. The loss of the services of our key engineering, sales, services or marketing personnel would harm our operations. For instance, loss of sales and customer service representatives could harm our relationship with the customers they serve, loss of engineers and development personnel could impede the development of product releases and enhancements and decrease our competitiveness, and departure of senior management personnel could result in a loss of confidence in our company by customers, suppliers and partners. None of our key personnel is bound by an employment agreement, and we do not maintain key person insurance on any of our employees. Because we, like many other technology companies, rely on stock options as a component of our employee compensation, if the market price of our common stock decreases or increases substantially, some current or potential employees may perceive our equity incentives as less attractive. In that case, our ability to attract and retain employees may be adversely affected.

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IF WE FAIL TO EXPAND OUR RELATIONSHIPS WITH THIRD-PARTY RESELLERS AND INTEGRATORS, OUR ABILITY TO GROW REVENUES COULD BE HARMED.

In order to grow our business, we must establish, maintain and strengthen relationships with third-parties, such as information technology ("IT") consultants and systems integrators as implementation partners, and hardware and software vendors as marketing partners. If these parties do not provide sufficient, high-quality service or integrate and support our software correctly, our revenues may be harmed. In addition, these parties may offer products of other companies, including products that compete with our products. Our contracts with third-parties may not require these third-parties to devote resources to promoting, selling and supporting our solutions. Therefore, we may have little control over these third-parties. We cannot assure you that we can generate and maintain relationships that offset the significant time and effort that are necessary to develop these relationships, or that, even if we are able to develop such relationships, these third-parties will perform adequately.

WE MAY NOT BE ABLE TO REDUCE OUR OPERATING EXPENDITURES AS AGGRESSIVELY AS PLANNED AND WE MAY NEED TO IMPLEMENT ADDITIONAL RESTRUCTURING ACTIVITIES.

In response to the current uncertain economic environment and volatility in the public equity markets, we recently implemented significant measures designed to reduce our operating expenses and enhance our ability to attain operating profitability. For example, from July 1, 2000, through September 30, 2001, we reduced our employee headcount by 182 persons, with reductions in virtually all areas of operations. We expect that our workforce reductions and other expense containment measures will allow us to continue operations into the foreseeable future.

In order to achieve operating profitability, we will need to maintain these cost savings in future quarters, without adversely affecting our revenue growth. Numerous factors could impede our ability to further manage our operating expenses. For instance, we currently expect to achieve significant expense reductions by limiting the headcount of our services organization; however, we may not be able to achieve the desired savings if we cannot engage and qualify third-party integration and support partners as rapidly as we hope. In addition, if our revenue growth fails to meet our current expectations, we would be forced to seek expense reductions in excess of our current plans, which may not be achievable. Any of these developments could impede our ability to achieve profitable operations in accordance with current expectations.

THE LENGTHY AND UNPREDICTABLE SALES CYCLES FOR OUR PRODUCTS AND RESISTANCE TO ADOPTION OF OUR SOFTWARE COULD CAUSE OUR OPERATING RESULTS TO FALL BELOW EXPECTATIONS.

Our operating results for future periods could be adversely affected because of unpredictable increases in our sales cycles. Our products and services have lengthy and unpredictable sales cycles varying from as little as three months to as much as nine months, which could cause our operating results to be below the expectations of analysts and investors. Since we are unable to control many of the factors that will influence our customers' buying decisions, it is difficult for us to forecast the timing and recognition of revenues from sales of our solutions.

Customers in our target market often take an extended time evaluating our products before purchasing them. Our products may have an even longer sales cycle in international markets. During the evaluation period, a variety of factors, including the introduction of new products or aggressive discounting by competitors and changes in our customers' budgets and purchasing priorities, may lead customers to not purchase or to scale down orders for our products.

As we target industry sectors and types of organizations beyond our core market of IT services consultancies, we may encounter increased resistance to use of business process automation solutions, which may further increase the length of our sales cycles, increase our marketing costs and reduce our revenues. Because we are pioneering a new solution category, we often must educate our prospective customers on the use and benefit of our solutions, which may cause additional delays during the evaluation process. These companies may be reluctant to abandon investments they have made in other systems in favor of our solution. In addition, IT departments of potential customers may resist purchasing our solutions for a variety of other reasons, particularly the potential displacement of their historical role in creating and running software, and concerns that packaged software products are not sufficiently customizable for their enterprises.

OUR SERVICES REVENUES HAVE A SUBSTANTIALLY LOWER MARGIN THAN OUR SOFTWARE LICENSE REVENUES, AND AN INCREASE IN SERVICES REVENUES RELATIVE TO LICENSE REVENUES COULD HARM OUR GROSS MARGINS.

A significant shift in our revenue mix away from license revenues to service revenues would adversely affect our gross margins. Revenues derived from the services we provide have substantially lower gross margins than revenues we derive from licensing our software. The relative contribution of services we provide to our overall revenues is subject to significant variation based on the structure and pricing of arrangements we enter into with customers in the future, and the extent to which our partners provide implementation, integration, training and maintenance services required by our customers. An increase in the percentage of total revenues generated by the services we provide could adversely affect our overall gross margins.

DIFFICULTIES WITH THIRD-PARTY SERVICES AND TECHNOLOGIES, AS WELL AS POWER INTERRUPTIONS, COULD DISRUPT OUR BUSINESS, AND MANY OF OUR COMMUNICATION AND HOSTING SYSTEMS DO NOT HAVE BACKUP SYSTEMS.

Many of our communications and hosting systems do not have backup systems capable of mitigating the effect of service disruptions. Our success in attracting and retaining customers for our Evolve application service provider ("ASP") offering and convincing them to increase their reliance on this solution depends on our ability to offer customers reliable, secure and continuous service. This requires that we provide continuous and error-free access to our systems and network infrastructure. We rely on third-parties to provide key components of our networks and systems. For instance, we rely on third-party Internet service providers to host applications for customers who purchase our solutions on an ASP basis. We also rely on third-party communications services providers for the high-speed connections that link our Web servers and office systems to the Internet. Any Internet or communications systems failure or interruption could result in disruption of our service or loss or compromise of customer orders and data. These failures, especially if they are prolonged or repeated, would make our services less attractive to customers and tarnish our reputation.

In addition, California has recently been experiencing electric power supply shortages that has resulted in intermittent loss of power in the form of rolling blackouts. While neither we nor our third-party Internet service providers or communications services providers have experienced any power failures to date that have prevented us from continuing our operations, the recurrence of blackouts may affect our ability to operate our business.

Finally, our third-party Internet and communications services providers have been and may continue to experience serious financial difficulties, which could result in the disruption of our ASP offering to our customers as well as potentially affecting our ability to operate our business. The financial difficulties of these third-party providers, especially if they go unresolved, would make our ASP offering less attractive to prospective and current customers and could tarnish our reputation.

OUR MARKETS ARE HIGHLY COMPETITIVE, AND COMPETITION COULD HARM OUR ABILITY TO SELL PRODUCTS AND SERVICES AND REDUCE OUR MARKET SHARE.

Competition could seriously harm our ability to sell additional software solutions and subscriptions on prices and terms favorable to us. The markets for our products are intensely competitive and subject to rapidly changing technology. We currently compete against providers of automation solutions for professional services organizations, such as Peoplesoft, Siebel and SAP. In addition, we may, in the future, face competition from providers of enterprise application software or electronic marketplaces. Companies in each of these areas may expand their technologies or acquire companies to support greater professional services automation functionality and capabilities. In addition, "in-house" information technology departments of potential customers have developed or may develop systems that substitute for some of the functionality of our product line.

Some of our competitors' products may be more effective than our products at performing particular functions or be more customized for particular customer needs. Even if these functions are more limited than those provided by our products, our competitors' software products could discourage potential customers from purchasing our products. A software product that provides some of the functions of our software solutions, but also performs other tasks may be appealing to these vendors' customers because it would reduce the number of different types of software necessary to effectively run their businesses. Further, many of our competitors may be able to respond more quickly than we can to changes in customer requirements.

Some of our competitors have longer operating histories, significantly greater financial, technical, marketing or other resources, or greater name recognition than we do. Our competitors may be able to respond more quickly than we can to new or emerging technologies and changes in customer requirements. Our competitors have made and may also continue to make strategic acquisitions or

establish cooperative relationships among themselves or with other software vendors. They may also establish or strengthen cooperative relationships with our current or future partners, limiting our ability to promote our products through these partners and limiting the number of consultants available to implement our software.

OUR REVENUES DEPEND ON ORDERS FROM OUR TOP CUSTOMERS, AND IF WE FAIL TO SECURE ONE OR MORE ORDERS, OUR REVENUES WILL BE REDUCED.

Historically, we have received a significant portion of our revenues in each fiscal period from a small number of customers. Accordingly, the loss of a single customer or customer prospect may have a substantial impact on our operating results if we depended on the sale of our products to that customer to meet our financial performance targets during a given fiscal period. Our agreements with existing customers often do not include long-term commitments from customers to continue to purchase our products. Moreover, a substantial percentage of new customer contracts are typically signed in the last few weeks of each fiscal quarter, and prospects we are pursuing have often made a decision not to purchase our products in the final stages of the sales cycle. Accordingly, our ability to meet our financial targets during each fiscal period is subject to substantial variation and uncertainty, and the loss of one or more customers or customer prospects can cause our operating results to fall below the expectations of investors and analysts and adversely affect our stock price.

IF OUR PRODUCTS DO NOT STAY COMPATIBLE WITH WIDELY USED SOFTWARE PROGRAMS, OUR REVENUES MAY BE ADVERSELY AFFECTED.

Our software products must work with widely used software programs. If these software programs and operating environments do not remain widely used, or we do not update our software to be compatible with newer versions of these programs and systems, we may lose customers.

Our software operates only on a computer server running both the Microsoft Windows NT or Sun Solaris operating system and database software from Microsoft or Oracle. In order to increase the flexibility of our solution and expand our client base, we must be able to successfully adapt it to work with other applications and operating systems. For example, we are in the early stages of customer deployment on the Sun Solaris operating system. Because this development effort is not complete, we cannot be certain that we will avoid significant technical difficulties that could delay or prevent completion of the development effort.

Our software connects to and uses data from a variety of our customers' existing software systems, including systems from Oracle and SAP. If we fail to enhance our software to connect to and use data from new systems of these products, we may lose potential customers.

THE COST AND DIFFICULTIES OF IMPLEMENTING OUR PRODUCTS COULD SIGNIFICANTLY HARM OUR REPUTATION WITH CUSTOMERS AND HARM OUR FUTURE SALES.

If our customers encounter unforeseen difficulties or delays in deploying our products and integrating them with their other systems, they may reverse their decision to use our solutions, which would reduce our future revenues, could impact the collection of outstanding receivables, and potentially damage our reputation. Factors that could delay or complicate the process of deploying our solutions include:

- customers may need to modify significant elements of their existing IT systems in order to effectively integrate them with our solutions;
- customers may need to establish and implement internal business processes within their organizations before they can make effective use of our software;
- customers may need to purchase and deploy significant additional hardware and software resources and may need to make significant investments in consulting and training services; and
- customers may rely on third-party systems integrators to perform all or a portion of the deployment and integration work, which reduces the control we have over the implementation process and the quality of

customer service provided to the customer.

OUR SALES ARE CONCENTRATED IN THE IT SERVICES CONSULTING INDUSTRY, AND, IF OUR CUSTOMERS IN THIS INDUSTRY DECREASE THEIR INFRASTRUCTURE SPENDING OR WE FAIL TO PENETRATE OTHER INDUSTRIES, OUR REVENUES MAY DECLINE.

Sales to customers in the IT services consulting industry accounted for 65% and 40% of our revenues in fiscal 2000 and 2001, respectively. Given the high degree of competition and the rapidly changing environment in this industry,

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there is no assurance that we will be able to continue sales in this industry at current levels. Many of our customers and potential customers in the IT services consultancy industry have witnessed drastic declines in their stock prices, which could limit our current customers from purchasing additional licenses of our software, and could prevent potential customers from making the kinds of infrastructure investments that would allow them to purchase our software in the first place. In addition, we intend to market our products to professional services departments of large organizations in other industries. Customers in these new industries are likely to have different requirements and may require us to change our product design or features, sales methods, support capabilities or pricing policies. If we fail to successfully address the needs of these customers, we may experience decreased sales in future periods.

IF OUR PRODUCTS CONTAIN SIGNIFICANT DEFECTS OR OUR SERVICES ARE NOT PERCEIVED AS HIGH QUALITY, WE COULD LOSE POTENTIAL CUSTOMERS OR BE SUBJECT TO DAMAGES.

Our products are complex and may contain currently unknown errors, defects, integration problems or other types of failures, particularly since new versions are frequently released. In the past we have discovered software errors in some of our products after introduction. We may not be able to detect and correct errors before releasing our products commercially. If our commercial products contain errors, we may:

- need to expend significant resources to locate and correct the errors;
- be required to delay introduction of new products or commercial shipment of products; or
- experience reduced sales and harm to our reputation from dissatisfied customers.

Our customers also may encounter system configuration problems that require us to spend additional consulting or support resources to resolve these problems.

Some of our customers have indicated to us that they want a completely integrated solution, including a single user interface and single database platform. While our product roadmap calls for such an integrated solution, any delays in delivering such a solution to our customers may cause them to downgrade their opinion of our software or to abandon our software.

Because our customers use our software products for critical operational and decision-making processes, product defects may also give rise to product liability claims. Although our license agreements with customers typically contain provisions designed to limit our exposure, some courts may not enforce all or part of these limitations. Although we have not experienced any product liability claims to date, we may encounter these claims in the future. Product liability claims, whether or not they have merit, could:

- divert the attention of our management and key personnel from our business;
- be expensive to defend; and

- result in large damage awards.

We do not have product liability insurance, and even if we obtain product liability insurance, it may not be adequate to cover all of the expenses resulting from such a claim.

OUR BUSINESS MAY SUFFER IF WE ARE NOT ABLE TO PROTECT OUR INTELLECTUAL PROPERTY.

Our success is dependent on our ability to develop and protect our proprietary technology and intellectual property rights. We seek to protect our software, documentation and other written materials primarily through a combination of patent, trade secret, trademark and copyright laws, confidentiality procedures and contractual provisions. While we have attempted to safeguard and maintain our proprietary rights, we do not know whether we have been or will be completely successful in doing so. Further, our competitors may independently develop or patent technologies that are substantially equivalent or superior to ours.

We have been issued a patent in the United States covering the enablement of dynamically configurable software systems by our Evolve software server. We also have two patent applications pending in the United States with respect to the "Team Builder" functionality in our Resource Manager module and the time and expense functionality of our Time and Expense module. There can be no assurance that either of these two applications would survive a legal challenge to its validity or provide significant protection to us. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary. Policing unauthorized use of our products is difficult. While we are unable to determine the extent to which piracy of our software products exists, software piracy can be expected to be a persistent problem, particularly in foreign countries where the laws may not protect proprietary rights as fully as in the United States. We can offer no assurance that our means of protecting its proprietary rights will be adequate or that our competitors will not reverse engineer or independently develop similar technology.

IF OTHERS CLAIM THAT WE ARE INFRINGING THEIR INTELLECTUAL PROPERTY, WE COULD INCUR SIGNIFICANT EXPENSES OR BE PREVENTED FROM SELLING OUR PRODUCTS.

We cannot provide assurance that others will not claim that we are infringing their intellectual property rights or that we do not in fact infringe those intellectual property rights. We have not conducted a search for existing intellectual property registrations, and we may be unaware of intellectual property rights of others that may cover some of our technology.

Any litigation regarding intellectual property rights could be costly and time-consuming and divert the attention of our management and key personnel from our business operations. The complexity of the technology involved and the uncertainty of intellectual property litigation increase these risks. Claims of intellectual property infringement might also require us to enter into costly royalty or license agreements.

We may not be able to obtain royalty or license agreements on terms acceptable to us, or at all. We also may be subject to significant damages or an injunction against use of our products. A successful claim of patent or other intellectual property infringement against us would have an immediate material adverse effect on our business and financial condition.

WE CONTINUE TO OPERATE INTERNATIONALLY, BUT WE MAY ENCOUNTER A NUMBER OF PROBLEMS IN DOING SO WHICH COULD LIMIT OUR FUTURE GROWTH.

We may not be able to successfully market, sell, deliver and support our products and services internationally. Any failure to build and manage effective international operations could limit the future growth of our business. Expansion into international markets will require significant management attention and financial resources to open additional international offices and hire international sales and support personnel. Localizing our products is difficult and may take longer than we anticipate because of difficulties in translation and delays we may experience in recruiting and training international staff. We are still in the process of developing local versions of our products, and we have limited experience in marketing, selling and supporting our products and services overseas. Doing business internationally involves greater expense and many additional risks, particularly:

- differences and unexpected changes in regulatory requirements, taxes, trade laws, tariffs, intellectual property rights and labor regulations;
- changes in a specific country's or region's political or economic conditions;
- greater difficulty in establishing, staffing and managing foreign operations; and
- fluctuating exchange rates.

SECURITY CONCERNS, PARTICULARLY RELATED TO THE USE OF OUR SOFTWARE ON THE INTERNET, MAY LIMIT THE EFFECTIVENESS OF AND REDUCE THE DEMAND FOR OUR PRODUCTS.

Despite our efforts to protect the confidential and proprietary information of our customers stored on our Evolve ASP solution via virtual private networks and other security devices, there is a risk that this information will be disclosed to unintended third-party recipients. To the extent our ability to implement secure private networks, on our Evolve ASP service, is impaired by technical problems, or by improper or incomplete procedural diligence by either ourselves or our customers, sensitive information could be exposed to inappropriate third-parties such as competitors of our customers, which may in turn expose us to liability and detrimentally impact our customers' confidence in our ASP service.

RESISTANCE TO ONLINE USE OF PERSONAL INFORMATION REGARDING EMPLOYEES AND CONSULTANTS MAY HINDER THE EFFECTIVENESS OF AND REDUCE DEMAND FOR OUR PRODUCTS AND SERVICES.

Companies store information on our ASP offering and on online networks created by our customers, which may include personal information of their employees, including employee backgrounds, skills, and other details. These employees may object to online compilation, transmission and storage of such information, or, despite our efforts to keep such personal information secure, this information may be delivered unintentionally to inappropriate third-parties such as recruiters. Enterprise applications like Evolve have always run on secure company intranets. The information contained in Evolve databases will be exposed to the unpredictable security of the Internet, which may create unforeseen liabilities for us. Evolve is currently targeted primarily to the North American market, but to the extent that European companies and customers will have access to it (given the global nature of the Internet), and to the extent that our services are utilized by Europeans, legal action grounded in European privacy laws could prevent our ASP service from succeeding in the European market.

POTENTIAL IMPOSITION OF GOVERNMENTAL REGULATION OR TAXATION ON ELECTRONIC

COMMERCE COULD LIMIT OUR GROWTH.

The adoption of new laws or the adaptation of existing laws to the Internet may decrease the growth in the use of the Internet, which could in turn decrease the demand for our solutions, increase our cost of doing business or otherwise have a material adverse impact on our business. Few laws or regulations currently directly apply to access commerce on the Internet. Federal, state, local and foreign governments are considering a number of legislative and regulatory proposals relating to Internet commerce. As a result, a number of laws or regulations may be adopted regarding Internet user privacy, taxation, pricing, quality of products and services and intellectual property ownership. How existing laws will be applied to the Internet in areas such as property ownership, copyright, trademark, trade secret and defamation is uncertain. The recent growth of Internet commerce has been attributed by some to the lack of sales and value-added taxes on interstate sales of goods and services over the Internet. Numerous state and local authorities have expressed a desire to impose such taxes on sales to businesses in their jurisdictions. The Internet Tax Freedom Act of 1998 prevents imposition of such taxes through October 2001. If the federal moratorium on state and local taxes on Internet sales is not renewed, or if it is terminated before its expiration, sales of goods and services over the Internet could be subject to multiple overlapping tax schemes, which could substantially hinder the growth of Internet-based commerce.

RISKS RELATED TO OUR STOCK

OUR OFFICERS, DIRECTORS AND AFFILIATED ENTITIES HAVE SIGNIFICANT CONTROL OVER US AND MAY APPROVE OR REJECT MATTERS CONTRARY TO YOUR VOTE OR INTERESTS.

Our executive officers and directors together with their affiliates beneficially own, or have rights to acquire, an aggregate of approximately 57.5% of our outstanding common stock. These stockholders, if acting together, will be able to significantly influence all matters requiring approval by our stockholders, including the election of directors and the approval of mergers or similar transactions, even if other stockholders disagree. In particular, Warburg Pincus Private Equity VIII, L.P. ("Warburg") owns or has the right to acquire securities with voting power equivalent to 55.0% of our outstanding capital stock. Furthermore, certain actions that we may wish to undertake require the consent of holders of a majority of our outstanding shares of Series A Preferred Stock, voting as a separate class. These actions include authorization and sale of certain senior securities, certain transactions involving a change of control of Evolve, the incurrence of significant indebtedness and the payment of dividends. With respect to these and other matters, the interests of the holders of our Series A Preferred Stock will not necessarily be identical to those of holders of our common stock. For instance, in the event of certain change of control transactions, the holders of Series A Preferred Stock are entitled to payment of a liquidation preference prior to payment of any consideration to the holders of our common stock. This may cause the holders of Series A Preferred Stock generally, and Warburg in particular, to favor or oppose a merger or sale of the Company or its assets in circumstances where many holders of common stock have a contrary desire. In such an instance, we may not be able to pursue the transaction in question even if it is supported by many or most holders of our common stock.

THE SALE OF A SUBSTANTIAL NUMBER OF SHARES OF COMMON STOCK COULD CAUSE THE MARKET PRICE OF OUR COMMON STOCK TO DECLINE.

Sales of a substantial number of shares of our common stock in the public market, or the appearance that such shares are available for sale, could adversely affect the market price for our common stock. The market price of our stock could also decline if one or more of our significant stockholders decided for any reason to sell substantial amounts of our stock in the public market. As of October 31, 2001, we had 40,830,111 shares of common stock outstanding.

Of these shares, 35,568,545 were freely tradable in the public market, either without restriction or subject, in some cases, only to S-3 or S-8/S-3 prospectus delivery requirements, and, in some cases, only to either manner of sale, volume, or notice requirements of Rule 144 under the Securities Act of 1933, as amended. An additional 3,044,817 shares will become eligible for sale, subject only to the manner of sale requirements of Rule 144, as our right to repurchase these shares lapses over time with the continued employment by Evolve of these stockholders. The remaining 2,216,749 shares that were outstanding as of October 31, 2001, will be freely tradable, subject only to Form S-3 delivery requirements and possibly restrictions under Rule 144, upon the effectiveness of the Form S-3 that was filed in September 2001, amended in October 2001 and expected to be amended again in November 2001 (as will an as-yet unspecified number of shares that are required to be issued as of the date the Form S-3 becomes effective). As of October 31, 2001, we also had 4,941,832 shares subject to outstanding options under our stock option plans (plus 215,000

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options and warrants issued outside of any plan), and 2,590,029 shares are available for future issuance under these plans. We have registered the shares of common stock subject to outstanding options and reserved for issuance under our stock option plans and 1,885,340 remaining shares of common stock are reserved for issuance under our 2000 Employee Stock Purchase Plan. Accordingly, shares underlying vested options will be eligible for resale in the public market as soon as they are purchased. As of October 31, 2001, we also had warrants outstanding to purchase a total of 6,509,167 of our common stock and a warrant to purchase up to 1.3 million shares of Series A Convertible Preferred Stock, which in turn is convertible to up to 26 million shares of common stock. If all the warrants for the Series A Convertible Stock are exercised, an additional common stock warrant for up to 6,500,000 shares of our common stock will be issued.

NASDAQ LISTING MAY BE AT RISK.

We failed to maintain the minimum closing bid price of $1.00 over 30 consecutive trading days as required by the Nasdaq National Market. Nasdaq has suspended this minimum bid price requirement through January 2, 2002. If the minimum bid price requirement is reinstated after that date and if we are unable to demonstrate compliance with any Nasdaq requirement, the Nasdaq staff may take further action with respect to a potential delisting of our stock. We may appeal any such decision by the Nasdaq staff to the Nasdaq Listing Qualifications Panel.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The following discusses our exposure to market risk related to changes in foreign currency exchange rates, interest rates, and equity prices. This discussion contains forward-looking statements that are subject to risks and uncertainties. Actual results could vary materially as a result of a number of factors including those set forth in the risk factors section of this prospectus.

FOREIGN CURRENCY EXCHANGE RATE RISK

To date, all our product sales have been made in North America and to a smaller extent, Europe. To the extent that our international operations become meaningful, our financial results could be affected by a variety of factors, including changes in foreign currency exchange rates or weak economic conditions in foreign markets. The strengthening of the U.S. dollar could make our products less competitive in foreign markets given that sales are currently made in U.S. dollars.

INTEREST RATE RISK

At September 30, 2001, we had cash, cash equivalents and investments of $11.7 million. Included in this balance is a short-term investment of $861,000. Declines in interest rates over time would reduce our interest income. Interest rate fluctuations would also affect interest paid on our line of credit and term loan credit facility.

Funds in excess of current operating requirements are invested in short-term investments principally consisting of commercial paper, government bonds and money-market institutions. Due to the nature of our investments, we have concluded that there is no material market risk exposure at September 30, 2001. Therefore, no quantitative tabular disclosures are presented.

The basic objectives of our investment program are to ensure:

- safety and preservation of capital;
- sufficient liquidity to meet cash flow requirements;
- attainment of a consistent market rate of return on invested funds; and
- avoiding inappropriate concentrations of investments.

EQUITY RISK

We do not own any marketable equity securities. Therefore, we are not subject to any direct equity price risk.

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PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we may become involved in litigation relating to claims arising from the ordinary course of business. For example, one of our early customers filed an action in the federal district court in Massachusetts and several other customers filed actions in either state or federal court in California, each alleging a variety of claims including that the software and services purchased from us did not satisfy certain contractual obligations or, in two cases, that we engaged in practices that they allege were unfair or misrepresentative. Certain of these claims were filed as counterclaims to actions instituted by us to collect outstanding receivables. All of these claims are still in the early stages of litigation, and it is, therefore, not possible to estimate the outcome of these contingencies.

In November 2001, a complaint seeking class action status was filed in the United States District Court for the Southern District of New York. The complaint is purportedly brought on behalf of all persons who purchased our common stock from August 4, 2000, through December 6, 2000. The complaint names as defendants some of our former and current officers, and several investment banking firms that served as managing underwriters of our initial public offering. As of the date of this report, neither the Company nor the individual defendants named had been served with the complaint. Among other things, the complaint alleges liability under the Securities Act of 1933 and the Securities Exchange Act of 1934, on the grounds that the registration statement for our initial public offering did not disclose that: (1) the underwriters had allegedly agreed to allow certain of their customers to purchase shares in the offering in exchange for alleged excess commissions paid to the underwriters; and (2) the underwriters had allegedly arranged for certain of their customers to purchase additional shares in the aftermarket at pre-determined prices under alleged arrangements to manipulate the price of the stock in aftermarket trading. We are aware that similar allegations have been made in numerous other lawsuits challenging initial public offerings conducted in 1998, 1999 and 2000. No specific amount of damages is claimed in the complaint involving our initial public offering. We intend to contest the claims vigorously. We are unable, at this time, to determine whether the outcome of the litigation will have a material impact on our results of operations or financial condition in any future period.

We believe that there are no other claims or actions pending or threatened against us, the ultimate disposition of which would have a material adverse effect on us.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

COMMON STOCK SALE

On September 27, 2001, we issued and sold 663,495 shares of common stock to Vivant! Corporation pursuant to the Asset Acquisition Agreement dated May 22, 2001, as additional consideration for the assets acquired from Vivant in June 2001. These shares were issued pursuant to Section 4(2) of the Securities Act of 1933, as amended (the "Securities Act"), in reliance on such entity's representations to us that it was acquiring the securities for investment purposes and not with any present intent to further distribute such securities.

SERIES A PREFERRED STOCK FINANCING

We completed the sale of Series A Preferred Stock pursuant to the Purchase Agreement (the "Series A Preferred Financing") on October 9, 2001. We issued the following securities and rights to the investors participating in the Series A Preferred Financing:

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

We received an aggregate purchase price of $13 million for the 1.3 million shares of Series A Preferred Stock sold. If the preferred stock warrants and the common stock warrants are exercised in full for cash, we will receive an additional $26 million in aggregate proceeds. We have no plans to issue additional shares of Series A Preferred Stock, other than upon exercise of the warrants described above. We intend to use the proceeds from the Series A Preferred Financing for general working capital purposes.

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The issuance of the Series A Preferred Stock and the warrants was exempt from the registration requirements of the Securities Act pursuant to Section 4(2) of the Securities Act, and Regulation promulgated thereunder. We relied on the fact that the securities were offered to a small group of investors without any public advertisement or solicitation, and on the fact that each of the investors represented that it was an "accredited investor" within the meaning of Rule 501 under the Securities Act and that it was purchasing the securities for investment purposes and not with any present intent to further distribute such securities.

Conversion Rights. Each share of Series A Preferred Stock is convertible into common stock at an initial conversion price of $0.50, or at an initial conversion rate of 20 shares of common stock for each share of Series A Preferred Stock. The conversion rate accretes at a rate of 8.00% per annum. The conversion rate is also subject to certain adjustments as set forth in our Certificate of Designation of Series A Preferred Stock, in the event of dilutive stock issuances and in the event we incur litigation- or tax-related expenses in excess of certain limitations. The Series A Preferred Stock may be converted at any time at the election of each holder. We may cause all of the shares of Series A Preferred Stock to be automatically converted into common stock at any time after the fifth anniversary of the date of initial issuance of these shares, provided that the common stock has been trading at a value of at least $5.00 for a specified period.

Liquidation Preference. In the event of a transaction involving a dissolution of our company, the holders of Series A Preferred Stock will be entitled to payment of a liquidation preference equal to the initial purchase price of their shares of Series A Preferred Stock, plus an 8.00% annual rate of return, prior to any payment to holders of common stock and other junior securities. In the event of certain transactions involving a change of control of our company, a liquidation preference equal to the initial purchase price of the Series A Preferred Stock shares held plus an 8.00% rate of return computed over a five-year period is payable to the holders of Series A Preferred Stock, irrespective of when such a transaction occurs.

Voting Rights. Holders of Series A Preferred Stock are generally entitled to one vote for each share of common stock into which their Series A Preferred Stock is convertible. In addition, we may not, without the affirmative vote of the holders of a majority of the outstanding shares of Series A Preferred Stock:

- amend or repeal the provisions of the Certificate of Designation of Series A Preferred Stock
- enter into a transaction involving a change of control, unless such transaction would result in aggregate consideration paid in respect of all Series A Preferred Stock equal to the original purchase price these shares, plus an internal rate of return of at least 50%
- authorize or issue any securities senior to the Series A Preferred Stock
- issue any debt obligations other than trade debt in the ordinary course of business
- pay any dividends on or repurchase any junior securities, subject to certain exceptions
- amend our bylaws to increase the authorized number of our directors to more than eight
- authorize or issue any shares of any class or series of stock on parity with the Series A Preferred Stock under certain circumstances.

Board Representation. The holders of the Series A Preferred Stock, voting as a separate class, are entitled to elect three members to our Board of Directors. All other directors will be elected by the holders of the common stock and the Series A Preferred Stock voting as a single class. The number of directors appointed by the holders of Series A Preferred Stock is reduced as follows:

- to two if less than 75% but at least 50% of the shares of Series A Preferred Stock remains outstanding, or if Warburg does not exercise preferred stock warrants to purchase at least 500,000 shares of Series A Preferred Stock prior to expiration of such warrants.
- to one if less than 50% but at least 25% of the shares of Series A

Preferred Stock remains outstanding

- to zero, if less than 25% of the shares of Series A Preferred Stock remain outstanding.

Preferred Stock Warrants. The preferred stock warrants are exercisable to purchase up to an aggregate of 1.3 million shares of Series A Preferred stock at a common stock-equivalent price of $.50 per share, payable in cash. 50% of the preferred stock warrants expire if not exercised within thirty days after our appointment of a new permanent Chief Executive Officer. If these first warrants are exercised in full, then the balance of the preferred stock warrants may be exercised for up to one year after issuance.

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Common Stock Warrants. The common stock warrants issued to the investors are exercisable for up to 6.5 million shares of common stock, and our Company will issue warrants to purchase up to an additional 6.5 million shares of common stock if the preferred stock warrants are exercised in full. The common stock warrants have an exercise price of $1.00 per share, which is subject to adjustment if we issue securities at less than fair market value and under certain other circumstances. The common stock warrants may be exercised for cash, or on a cashless basis by converting the common stock warrants into a number of shares with a value equal to the spread between the market value of the shares subject to the common stock warrants and the exercise price. In addition, in the event of certain transactions involving a change of control of Evolve, holders of common stock warrants will have the right to deliver these warrants to us in exchange for payments equal to the market value of such warrants at the time of the change of control transaction, payable in cash or, subject to certain conditions, shares of common stock of Evolve. The common stock warrants have a term of seven years

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

EXHIBIT NO.	
10.18	Loan Amendment Agreement, dated November 13, 2001, between Registrant and Imperial Bank.

(b) Reports on Form 8-K:

- On September 27, 2001, we filed a current report on Form 8-K regarding the issued press release announcing that we had entered into an agreement to sell shares of our Series A Preferred Stock and warrants to purchase additional shares of its Series A Preferred Stock and

Common Stock.

- On July 17, 2001, we filed a Current Report on Form 8-K relating to the Registrant's Asset Acquisition of Vivant Corporation.

SIGNATURE

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

Date: November 14, 2001 /s/ KENNETH J. BOZZINI

Kenneth J. Bozzini
Chief Financial Officer and Vice President of Finance (Duly Authorized Officer and Principal Financial and Accounting Officer)