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PREDICTIVE SYSTEMS INC  
Form 10-Q  
August 14, 2001

U.S. SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934 FOR THE QUARTERLY PERIOD ENDING June 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: 333-84045

PREDICTIVE SYSTEMS, INC.

-----  
(Exact Name of Registrant as Specified in its Charter)

DELAWARE

13-3808483

-----  
(State or other Jurisdiction of  
Incorporation or Organization)

-----  
(I.R.S. Employer Identification Number)

417 FIFTH AVENUE, NEW YORK, NEW YORK

10016

-----  
(Address of Principal Executive Offices)

-----  
(Zip Code)

(212) 659-3400

-----  
(Registrant's Telephone Number, Including Area Code)

Check whether the registrant: (1) filed all reports required to be filed by  
Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such  
shorter period that the registrant was required to file such reports), and (2)  
has been subject to such filing requirements for the past 90 days.

Yes

No

As of August 9, 2001, there were 36,252,089 shares of the registrant's common  
stock, \$.001 par value per share, outstanding.

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PREDICTIVE SYSTEMS, INC. AND SUBSIDIARIES

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PART 1. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

PREDICTIVE SYSTEMS, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS

June 30,

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(unaudi

ASSETS

Current assets

Cash and cash equivalents

\$ 5

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Investment in marketable securities, at market value		
Accounts receivable - net of allowance for doubtful accounts of \$1,487,378 and \$1,292,491, respectively		1
Unbilled work in process		
Inventory held for resale		
Related party receivables		
Receivables from employees and stockholders		
Prepaid expenses and other current assets		
Total current assets		9
Property and equipment - net of accumulated depreciation and amortization of \$4,693,895 and \$3,363,265, respectively		1
Intangible assets - net of accumulated amortization of \$15,913,489 and \$3,238,598, respectively		10
Long-term investments in related parties		
Other assets		
Total assets		\$ 21
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	\$	
Accrued compensation		
Accrued expenses and other current liabilities		1
Current portion of capital lease obligations		
Deferred income		
Total current liabilities		2
Noncurrent liabilities		
Capital lease obligations		
Deferred rent		
Deferred income tax liability		
Total noncurrent liabilities		
Total liabilities		2
Commitments and contingencies		
Stockholders' equity		
Common stock, \$.001 par value, 200,000,000 shares authorized, 36,201,816 and 34,903,696 shares issued and outstanding		22
Additional paid-in capital		
Deferred compensation		
Accumulated deficit		(4
Accumulated other comprehensive (loss) income		

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Total stockholders' equity	18
	-----
Total liabilities and stockholders' equity	\$ 21
	=====

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

PREDICTIVE SYSTEMS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	Three Months Ended June 30	
	2001	2000
	-----	-----
Revenues:		
Professional services	\$ 17,841,371	\$ 22,067,108
Hardware and software sales	491,831	1,307,860
	-----	-----
Total revenues	18,333,202	23,374,968
	-----	-----
Cost of revenues:		
Professional services	12,868,216	11,168,771
Hardware and software purchases	896,031	999,745
	-----	-----
Total cost of revenues	13,764,247	12,168,516
	-----	-----
Gross profit	4,568,955	11,206,452
	-----	-----
Sales and marketing	4,729,089	3,125,963
General and administrative	12,054,038	6,425,231
Depreciation and amortization	953,284	438,423
Intangibles amortization	6,300,112	213,177
Restructuring and other charges	3,663,817	--
Loss on long-term investment in related party	--	--
Noncash compensation expense	107,969	19,039
	-----	-----
Operating expenses	27,808,309	10,221,833
	-----	-----
Operating (loss) profit	(23,239,354)	984,619
	-----	-----
Other income (expense):		
Interest income	752,403	1,956,704
Other expense	(75,669)	(1,631)
Interest expense	(83,744)	(13,837)
	-----	-----

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(Loss) income before income tax provision	(22,646,364)	2,925,855
Income tax provision	--	1,261,909
	-----	-----
Net (loss) income	\$ (22,646,364)	\$ 1,663,946
	=====	=====
Net (loss) income per share: Basic	\$ (0.63)	\$ 0.07
	=====	=====
Net (loss) income per share: Diluted	\$ (0.63)	\$ 0.05
	=====	=====
Weighted average shares outstanding: Basic	35,952,843	25,525,718
	=====	=====
Weighted average shares outstanding: Diluted	35,952,843	34,158,073
	=====	=====

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

PREDICTIVE SYSTEMS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	-----	S
		2001
		-----
Cash flows from operating activities:		
Net (loss) income	\$	(4)
Adjustments to reconcile net (loss) income to net cash used in operating activities:		
Noncash compensation expense		
Deferred income taxes		
Depreciation and amortization		1
Bad debt expense		
Loss on long-term investment in related party		
Write-off of software inventory		
Noncash component of restructuring and other charges		
(Increase) decrease in-		
Accounts receivable		
Unbilled work in process		
Inventory held for resale		(
Income taxes		
Prepaid expenses and other assets		(
Increase (decrease) in-		
Accounts payable		
Accrued expenses and other current liabilities		
Deferred income		
Income taxes		
Deferred rent		
		-----
Net cash used in operating activities		(1

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Cash flows from investing activities:

Proceeds from sale or redemption (purchase) of marketable securities, net  
 (Payments to) repayments from employees, net  
 Loans to stockholders  
 Adjustments to purchase price for fiscal 2000 acquisitions  
 Purchase of property and equipment, net

Net cash used in investing activities

Cash flows from financing activities:

Principal payments on capital leases  
 Proceeds from sale of stock through ESPP  
 Proceeds from sale of common stock, net of expenses  
 Proceeds from exercise of stock options

Net cash provided by financing activities

Effects of exchange rates

Net (decrease) increase in cash

Cash and cash equivalents - beginning of period

Cash and cash equivalents - end of period

Supplemental disclosures of cash flow information:

Cash paid during the year for:  
 Interest

Taxes

Supplemental disclosures on noncash investing and financing activities:

Noncash adjustment to purchase price for fiscal 2000 acquisitions

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (unaudited)

(1) BASIS OF PRESENTATION

The consolidated financial statements and accompanying financial  
 information as of June 30, 2001 and for the three and six months ended  
 June 30, 2001 and 2000 are unaudited and, in the opinion of management,  
 include all adjustments (consisting only of normal recurring

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adjustments) which the Company considers necessary for a fair presentation of the financial position of the Company at such dates and the operating results and cash flows for those periods. The financial statements included herein have been prepared in accordance with generally accepted accounting principles and the instructions of Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. These financial statements should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2000. Results for interim periods are not necessarily indicative of results for the entire year.

### (2) ACQUISITIONS

On October 16, 2000, the Company acquired Synet Service Corporation ("Synet") in a transaction accounted for as a purchase. Synet is a network and systems management consulting firm that works with organizations to improve the availability and reliability of e-commerce applications and network infrastructure. The consideration for the acquisition consisted of an aggregate of 1,922,377 shares of common stock at a fair value of \$11.00 per share, par value \$0.001 per share, \$9,000,000 cash paid upon closing of the transaction and transaction expenses of \$1,085,417, of which approximately \$853,000 were paid as of June 30, 2001. Approximately 522,000 shares were accounted for as stock options until a related note was repaid in December 2000, at which time the shares were considered to be issued for accounting purposes. The Company also issued options to purchase 242,459 shares of common stock to employees of Synet in exchange for their Synet options. These options had a fair value of \$1,110,893 and were accounted for as additional purchase price. The Company acquired net tangible assets of \$169,482 and recorded intangible assets of approximately \$33.4 million, which represented customer lists, workforce and excess of the purchase price over the fair value of the net tangible assets of approximately \$30.4 million. Additionally, the Company recognized a deferred income tax liability of \$1,184,620 related to the nondeductibility of certain acquired identifiable intangibles. In 2001, the Company recorded an additional \$342,000 to the purchase price for the closing of certain offices and a reduction in workforce in connection with the Company's acquisition plan. This amount consisted of \$301,000 for severance benefits for 16 employees laid-off and \$41,000 for exit costs related to real estate. As of June 30, 2001, \$204,000 of severance benefits remained unpaid and is reflected in accrued expenses and other current liabilities. Goodwill and the intangible assets are being amortized on a straight-line basis over periods of three to five years. The results of operations of Synet have been included in the results of operations of the Company since the date of acquisition.

On December 14, 2000, the Company acquired Global Integrity Corporation ("Global Integrity") in a transaction accounted for as a purchase. Global Integrity provides information security services to Fortune 500 and Global 1000 companies. The consideration for the acquisition consisted of an aggregate of 5,240,275 shares of common stock at a fair value of \$8.15 per share, par value \$0.001 per share, \$31,460,270 cash paid upon the closing of the transaction and transaction expenses of \$1,830,162, of which all have been paid as of June 30, 2001. The Company also issued options to purchase 551,048 shares of common stock to employees of Global Integrity in exchange for their Global Integrity options. These options had a fair value of \$2,271,434 and were accounted for as additional purchase price. Additionally, the Global Integrity stockholders and optionholders have the right to earn up to an additional \$14,012,500 in value (to be paid in cash to stockholders

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and additional options to optionholders) upon the achievement of certain revenue milestones by the acquired business. The Company acquired net tangible assets of \$4,313,033 and recorded intangible assets of approximately \$81.3 million, which represented customer lists, workforce, tradenames, developed technology and excess of the purchase price over the fair value of the net tangible assets of approximately \$63.0 million. Additionally, the Company recognized a deferred income tax liability of \$7,308,222 related to the

nondeductibility of certain acquired identifiable intangibles. In 2001, the Company recorded an additional \$2.4 million to the purchase price for the closing of certain offices and a reduction in workforce in connection with the Company's acquisition plan. This amount consisted of \$185,000 for severance benefits for 15 employees laid-off and \$2.2 million for exit costs related to real estate. As of June 30, 2001, \$1.6 million remained unpaid for severance benefits and exit costs. Such amount is reflected in accrued expenses and other current liabilities. Goodwill and the intangible assets are being amortized on a straight-line basis over periods of three to five years. The results of operations of Global Integrity have been included in the results of operations of the Company since the date of acquisition.

The following unaudited information presents the pro forma results of operations for the Company for the three and six months ended June 30, 2000 as if the acquisitions of Synet and Global Integrity had occurred on the first day of these periods.

		Three Months June 30, -----
		(unaudited)
Revenues	\$	2
Net loss	\$	(
Per Share Information:		
Net loss per share - Basic and Diluted	\$	
Weighted average shares outstanding - Basic and Diluted	\$	3

### (3) NET (LOSS) INCOME PER SHARE

Basic net (loss) income per share is computed by dividing net (loss) income available to common stockholders by the weighted average number of shares outstanding. Diluted net (loss) income per share reflects the potential dilution that would occur if securities or other contracts to issue common stock were exercised or converted into common stock, unless they are antidilutive.

The following table reconciles the numerator and denominator for the calculation:



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	Three Months Ended June 30	
	2001	2000
	(unaudited)	
Numerator -		
Net (loss) income	\$ (22,646,364)	\$ 1,663,946
Denominator -		
Denominator for basic earnings per share - weighted average shares outstanding	35,952,843	25,525,718
Effect of dilutive securities - Incremental shares for assumed conversion of options	--	8,632,355
Denominator for diluted earnings per share - weighted average shares outstanding	35,952,843	34,158,073
Net (loss) income per share -		
Basic	\$ (0.63)	\$ 0.07
Diluted	\$ (0.63)	\$ 0.05

(4) COMPREHENSIVE (LOSS) INCOME

The Company adopted Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income," which established standards for reporting and displaying comprehensive income and its components. The components of comprehensive (loss) income are as follows:

	Three Months Ended June 30	
	2001	2000
	(unaudited)	

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Net (loss) income	\$ (22,646,364)	\$ 1,663,946
Unrealized (loss) gain on investments	(6,972)	(19,413)
Foreign currency translation adjustment	97,028	(120,180)
Comprehensive (loss) income	\$ (22,556,308)	\$ 1,524,353
	=====	=====

### (5) RESTRUCTURING AND OTHER CHARGES

In February 2001, the Company's management foresaw the need to lower the operating costs of the business given its near-term revenue projections. Therefore, the Company established a plan that included the following: (1) a reduction in its workforce for both domestic and international operations related to professional consultant employees that had been underutilized for several months and also to employees that held various management, sales and administrative positions deemed to be duplicative functions; (2) the closing of several domestic and international regional offices located in geographic areas that no longer cost justified remaining open; and (3) the discontinuance of electronic equipment leases and other expenses related to the reduction in workforce.

As of June 30, 2001, 138 employees were laid-off. The Company recorded restructuring charges of \$3,275,033, of which \$1,620,852 remained unpaid as of June 30, 2001. Such charges consisted of \$1,683,473 in severance benefits, \$1,458,614 in exit costs related to real estate and electronic equipment, and \$132,946 in other related expenses. These charges have been reflected as operating expenses of the Company.

In June 2001, the Company wrote-off approximately \$1,030,000 related to internal software management tools that no longer suited the business needs of the Company.

### (6) EFFECTS OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In June 1998, the FASB issued SFAS No. 133 ("SFAS 133"), "Accounting for Derivative Instruments and Hedging Activities." SFAS 133 establishes accounting and reporting standards requiring that every derivative instrument be recorded in the balance sheet as either an asset or liability measured at its fair value. SFAS 133 requires that changes in the derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. SFAS 133 is effective for fiscal years beginning after June 15, 1999. In July 1999, the FASB approved SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities-Deferral of the Effective Date of SFAS 133", which amends SFAS 133 to be effective for all fiscal quarters of all fiscal years beginning after June 15, 2000. As the Company currently

does not engage in derivative instruments or hedging activities, the adoption of this accounting principle did not have a material impact on the Company's financial position or results of operations.

In July 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 141, Business Combinations ("SFAS 141") and No. 142, Goodwill and Other Intangible Assets ("SFAS 142"). SFAS 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. Under SFAS 142,

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goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment. Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives (but with no maximum life). The amortization provisions of SFAS 142 apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, the Company is required to adopt SFAS 142 effective January 1, 2002. The Company is currently evaluating the effect that adoption of the provisions of SFAS 142 that are effective January 1, 2002 will have on its results of operations and financial position.

### (7) SUBSEQUENT EVENTS

In August 2001, the Company laid-off approximately 63 employees in connection with the restructuring plan. These employees consisted primarily of field consultants and sales personnel. The Company also closed additional domestic offices located in geographic areas that no longer cost justified remaining open. The Company will record restructuring charges for severance payments of approximately \$600,000 and exit costs related to real estate of approximately \$2.9 million.

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

THIS REPORT CONTAINS FORWARD-LOOKING STATEMENTS RELATING TO FUTURE EVENTS AND FUTURE PERFORMANCE OF THE COMPANY WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933 AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, INCLUDING, WITHOUT LIMITATION, STATEMENTS REGARDING THE COMPANY'S EXPECTATIONS, BELIEFS, INTENTIONS OR FUTURE STRATEGIES THAT ARE SIGNIFIED BY THE WORDS "EXPECTS", "ANTICIPATES", "INTENDS", "BELIEVES" OR SIMILAR LANGUAGE. ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE ANTICIPATED IN SUCH FORWARD-LOOKING STATEMENTS. ALL FORWARD-LOOKING STATEMENTS INCLUDED IN THIS DOCUMENT ARE BASED ON INFORMATION AVAILABLE TO THE COMPANY ON THE DATE HEREOF, AND THE COMPANY ASSUMES NO OBLIGATION TO UPDATE ANY FORWARD LOOKING STATEMENTS. THE COMPANY CAUTIONS INVESTORS THAT ITS BUSINESS AND FINANCIAL PERFORMANCE ARE SUBJECT TO SUBSTANTIAL RISKS AND UNCERTAINTIES. IN EVALUATING THE COMPANY'S BUSINESS, PROSPECTIVE INVESTORS SHOULD CAREFULLY CONSIDER THE INFORMATION SET FORTH BELOW UNDER THE CAPTION "RISK FACTORS" IN ADDITION TO THE OTHER INFORMATION SET FORTH HEREIN AND ELSEWHERE IN THE COMPANY'S OTHER PUBLIC FILINGS WITH THE SECURITIES AND EXCHANGE COMMISSION.

Substantially all of our revenues are derived from professional services. We provide network consulting services to our clients on either a project outsource or collaborative consulting basis. We derive revenues from these services on both a fixed-price, fixed-time basis and on a time-and-expense basis. We use our BusinessFirst methodology to estimate and propose prices for our fixed-price projects. The estimation process accounts for standard billing rates particular to each project, the client's technology environment, the scope of the project and the project's timetable and overall technical complexity. A member of our senior management team must approve all of our fixed-price proposals in excess of \$500,000. For these contracts, we recognize revenue using a percentage-of-completion method primarily based on costs incurred. We make provisions for estimated losses on uncompleted contracts on a contract-by-contract basis and recognize such provisions in the period in which the losses are determined. Professional services revenues for time-and-expense based projects are recognized as services are performed. Any payments received

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in advance of services performed are recorded as deferred revenue. Our clients are generally able to reduce or cancel their use of our professional services without penalty and with little or no notice. We also derive limited revenues from the sale of hardware and software. We sell hardware and software only when specifically

requested by a client. We expect revenues from the sale of hardware and software to continue to decline on a percentage basis.

Since we recognize professional services revenues only when our consultants are engaged on client projects, the utilization of our consultants is important in determining our operating results. In addition, a substantial majority of our operating expenses, particularly personnel and related costs, depreciation and rent, are relatively fixed in advance of any particular quarter. As a result, any underutilization of our consultants may cause significant variations in our operating results in any particular quarter and could result in losses for such quarter. Factors which could cause underutilization include:

- the reduction in size, delay in commencement, interruption or termination of one or more significant projects;
- the completion during a quarter of one or more significant projects;
- the miscalculation of resources required to complete new or ongoing projects; and
- the timing and extent of training, weather related shut-downs, vacations and holidays.

Our cost of revenues consist of costs associated with our professional services and hardware and software purchases. Costs of revenues associated with professional services include compensation and benefits for our consultants and project-related travel expenses. Costs of hardware and software purchases consist of acquisition costs of third-party hardware and software resold.

In April 2000, we consummated a follow-on public offering for 3.8 million shares of our common stock, of which 1.0 million shares were offered by the Company resulting in net proceeds of approximately \$39.8 million after deducting underwriter discounts and commissions, and expenses as payable by us.

On October 16, 2000, we acquired Synet Service Corporation for an aggregate purchase price of approximately \$32.3 million. The purchase price was paid in the form of 1,922,377 shares of our common stock, options to purchase 242,459 shares of our common stock and \$9.0 million in cash in exchange for all of the outstanding capital stock of Synet. The acquisition was accounted for as a purchase and resulted in intangible assets of approximately \$33.4 million representing the customer lists, workforce and excess of the purchase price over the fair value of the net tangible assets acquired. During 2001, the Company adjusted the purchase price for \$342,000 for the closing of certain offices and a reduction in workforce in connection with the acquisition plan. The intangible assets are being amortized over a period of 3-5 years.

On December 14, 2000, we acquired Global Integrity Corporation for an aggregate purchase price of approximately \$78.3 million. The purchase price was paid in the form of 5,240,275 shares of our common stock, options to purchase 551,048 shares of common stock and \$31.5 million in cash in exchange for all of the

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outstanding capital stock of Global Integrity. The acquisition was accounted for as a purchase and resulted in intangible assets of approximately \$81.3 million representing the customer lists, workforce, tradenames, developed technology and excess of the purchase price over the fair value of the net tangible assets acquired. During 2001, the Company adjusted the purchase price for \$2.4 million for the closing of certain offices and a reduction in workforce in connection with the acquisition plan. The intangible assets are being amortized over a period of 3-5 years.

Given the decline in revenue related to the service provider customer base, coupled with the continuing uncertainty in the professional network consulting services marketplace, we believe that our quarterly revenue and operating results are likely to vary significantly in the future and that period-to-period comparisons of our operating results are not necessarily meaningful and should not be relied on as indications of future performance.

### RESULTS OF OPERATIONS

Three Months Ended June 30, 2001 and 2000

**REVENUES.** Revenues decreased 21.6% to \$18.3 million in the three months ended June 30, 2001 from \$23.4 million in the three months ended June 30, 2000. Revenues from professional services decreased 19.1% to \$17.8 million in the three months ended June 30, 2001 from \$22.1 million in the three months ended June 30, 2000. This decrease was primarily due to the severe contraction in spending by telecom service providers in both domestic and international operations and difficult market conditions in the enterprise sector. Revenues from hardware and software sales decreased 62.4% to \$492,000 in the three months ended June 30, 2001 from \$1.3 million in the three months ended June 30, 2000. This decrease was primarily due to a decline in client requests for hardware and software in connection with professional services projects. During the three months ended June 30, 2001, BellSouth Corporation accounted for 20.2% of our revenues. The number of our billable consultants increased to 416 as of June 30, 2001 from 377 as of June 30, 2000.

**GROSS PROFIT.** Gross profit decreased 59.2% to \$4.6 million in the three months ended June 30, 2001 from \$11.2 million in the three months ended June 30, 2000. As a percentage of revenues, gross profit decreased to 24.9% in the three months ended June 30, 2001 from 47.9% in the three months ended June 30, 2000. This decrease in gross profit is a result of a decrease in utilization of the related consultants in addition to the write-off of \$500,000 of software inventory which was no longer deemed to be saleable. Excluding the impact of this write-off, gross margin was 27.6% for the three months ended June 30, 2001. Cost of revenues increased 13.1% to \$13.8 million in the three months ended June 30, 2001 from \$12.2 million in the three months ended June 30, 2000. This increase in cost of revenues was due primarily to an increase in compensation and benefits paid to consultants in addition to the \$500,000 write-off of software inventory.

**SALES AND MARKETING EXPENSES.** Sales and marketing expenses increased 51.3% to \$4.7 million in the three months ended June 30, 2001 from \$3.1 million in the three months ended June 30, 2000. As a percentage of revenues, sales and marketing expenses increased to 25.8% in the three months ended June 30, 2001 from 13.4% in the three months ended June 30, 2000. The increase in absolute dollars was primarily due to an increase of \$191,000 in commissions paid, an increase of \$1.4 million in compensation and benefits paid due to the hiring of additional personnel and the acquisitions of Synet and Global Integrity, and an increase of \$25,000 in sales and marketing efforts.

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GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses increased 87.6% to \$12.1 million in the three months ended June 30, 2001 from \$6.4 million in the three months ended June 30, 2000. As a percentage of revenues, general and administrative expenses increased to 65.7% in the three months ended June 30, 2001 from 27.5% in the three months ended June 30, 2000. The increase in absolute dollars was primarily due to an increase of \$1.8 million in compensation and benefits costs due to the continued investment in our domestic organization and European corporate staff, an increase of \$798,000 in facilities and equipment leases reflecting the continued investment in our infrastructure, an increase of \$917,000 in bad debt expense, and an increase of \$2.2 million in professional services and other administrative costs.

DEPRECIATION AND AMORTIZATION. Depreciation and amortization increased 117.4% to \$953,000 in the three months ended June 30, 2001 from \$438,000 in the three months ended June 30, 2000. This increase was due to purchases of additional computer equipment to support our growth offset by write-offs of leasehold improvements in connection with the restructuring plan.

INTANGIBLES AMORTIZATION. Amortization of intangibles increased to \$6.3 million for the three months ended June 30, 2001 from \$213,000 for the three months ended June 30, 2000. For the three months ended June 30, 2001, the amount consisted of \$213,000 amortization of intangibles related to the acquisition of Network Resource Consultants and Company B.V. ("NRCC") in August 1999, \$1.7 million amortization of intangibles related to the acquisition of Synet in October 2000 and \$4.4 million amortization of intangibles related to the acquisition of Global Integrity in December 2000. For the three months ended June 30, 2000, amortization was solely related to intangibles as a result of the NRCC acquisition.

RESTRUCTURING AND OTHER CHARGES. For the three months ended June 30, 2001, the Company laid-off 68 employees in connection with its restructuring plan. These employees consisted primarily of employees who

held certain administrative and management positions deemed to be duplicative functions. Amounts recognized as restructuring charges are \$1.1 million in severance benefits, \$1.5 million in exit costs related to real estate and electronic equipment, and \$133,000 in other related expenses related to the reduction in force. Additionally, included in this financial statement caption for the three months ended June 30, 2001, is \$1,030,000 related to the write-off of internal software management tools that no longer suit the business needs of the Company.

NONCASH COMPENSATION EXPENSE. During 1999, the Company granted options to purchase shares of common stock at exercises prices that were less than the fair market value of the underlying shares of common stock resulting in deferred compensation. During 2000, related to the acquisition of Synet and Global Integrity, the Company issued options to Synet and Global Integrity optionholders in exchange for their Synet and Global Integrity options, respectively. The unvested portion of the Synet and Global Integrity options resulted in deferred compensation. These transactions result in noncash compensation expense over the period that these specific options vest. During the three months ended June 30, 2001 and 2000, the Company recorded approximately \$108,000 and \$19,000, respectively, of noncash compensation expenses related to these options.

OTHER INCOME (EXPENSE). Other income decreased to \$593,000 in the three months ended June 30, 2001 from \$1.9 million in the three months ended June 30, 2000.

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This decrease was primarily due to a decrease in interest income as a result of the utilization of cash and cash equivalents to fund current operating needs, the Synet and Global Integrity acquisitions, and a general decline in interest rates.

INCOME TAXES. For the three months ended June 30, 2001 the benefit for income taxes was fully offset by valuation allowances. For the three months ended June 30, 2000, the income tax provision was \$1.3 million on pre-tax income of approximately \$2.9 million. The difference in the effective tax rates relates to the provision for a valuation allowance against net operating losses and an increase in expenses not deductible for tax purposes.

Six Months Ended June 30, 2001 and 2000

REVENUES. Revenues decreased 7.8% to \$39.1 million in the six months ended June 30, 2001 from \$42.4 million in the six months ended June 30, 2000. Revenues from professional services decreased 6.8% to \$38.2 million in the six months ended June 30, 2001 from \$41.0 million in the six months ended June 30, 2000. This decrease was primarily due to the severe contraction in spending by telecom service providers in both domestic and international operations and difficult market conditions in the enterprise sector. Revenues from hardware and software sales decreased to \$893,000 in the six months ended June 30, 2001 from \$1.5 million in the six months ended June 30, 2000. This decrease was primarily due to a decline in client requests for hardware and software in connection with professional services projects. During the six months ended June 30, 2001, BellSouth Corporation accounted for 19.1% of our revenues. The number of our billable consultants increased to 416 as of June 30, 2001 from 377 as of June 30, 2000.

GROSS PROFIT. Gross profit decreased 51.9% to \$9.8 million in the six months ended June 30, 2001 from \$20.4 million in the six months ended June 30, 2000. As a percentage of revenues, gross profit decreased to 25.2% in the six months ended June 30, 2001 from 48.2% in the six months ended June 30, 2000. This decrease in gross profit is a result of a decrease in utilization of the related consultants in addition to the write-off of \$500,000 of software inventory which was deemed to be no longer saleable. Excluding the impact of this write-off, gross margin was 26.4% for the six months ended June 30, 2001. Cost of revenues increased 33.1% to \$29.3 million in the six months ended June 30, 2001 from \$22.0 million in the six months ended June 30, 2000. This increase in cost of revenues was due primarily to an increase in compensation and benefits paid to consultants in addition to the \$500,000 write-off of software inventory.

SALES AND MARKETING EXPENSES. Sales and marketing expenses increased 60.8% to \$9.3 million in the six months ended June 30, 2001 from \$5.8 million in the six months ended June 30, 2000. As a percentage of revenues, sales and marketing expenses increased to 23.8% in the six months ended June 30, 2001 from 13.6% in the six months ended June 30, 2000. The increase in absolute dollars was primarily due to an increase of \$659,000 in commissions paid, an increase of \$2.5 million in compensation and benefits paid due to the hiring of additional personnel and the acquisitions of Synet and Global Integrity, and an increase of \$375,000 in sales and marketing efforts.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses increased 101.8% to \$23.9 million in the six months ended June 30, 2001 from \$11.9 million in the six months ended June 30, 2000. As a

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percentage of revenues, general and administrative expenses increased to 61.2% in the six months ended June 30, 2001 from 28.0% in the six months ended June 30, 2000. The increase in absolute dollars was primarily due to an increase of \$4.3 million in compensation and benefits costs due to the continued investment in our domestic organization and European corporate staff, an increase of \$2.1 million in facilities and equipment leases reflecting the continued investment in our infrastructure, an increase of \$1.5 million in bad debt expense, and an increase of \$4.1 million in professional services and other administrative costs.

DEPRECIATION AND AMORTIZATION. Depreciation and amortization increased 141.1% to \$1.7 million in the six months ended June 30, 2001 from \$713,000 in the six months ended June 30, 2000. This increase was due to purchases of additional computer equipment to support our growth offset by write-offs of leasehold improvements in connection with the restructuring plan.

INTANGIBLES AMORTIZATION. Amortization of intangibles increased to \$12.7 million for the six months ended June 30, 2001 from \$426,000 for the six months ended June 30, 2000. For the six months ended June 30, 2001, the amount consisted of \$426,000 amortization of intangibles related to the acquisition of NRCC in August 1999, \$3.5 million amortization of intangibles related to the acquisition of Synet in October 2000 and \$8.8 million amortization of intangibles related to the acquisition of Global Integrity in December 2000. For the six months ended June 30, 2000, amortization was solely related to intangibles as a result of the NRCC acquisition.

RESTRUCTURING AND OTHER CHARGES. For the six months ended June 30, 2001, the Company laid-off 138 employees in connection with its restructuring plan. These employees consisted of field consultants that were under performing as well as employees who held certain administrative and management positions deemed to be duplicative functions. Amounts recognized as restructuring charges included \$1.7 million in severance benefits, \$1.5 million in exit costs related to real estate and electronic equipment, and \$133,000 in other related expenses related to the reduction in force. Additionally, included in the financial statement caption for the six months ended June 30, 2001 is \$1,030,000 related to the write-off of internal software management tools that no longer suit the business needs of the Company.

LOSS ON LONG-TERM INVESTMENT IN RELATED PARTY. On March 22, 2001, Paradigm4, Inc. filed for federal bankruptcy protection. This action created significant uncertainty regarding the Company's investment in Paradigm4. As a result, the Company has recognized a loss on its \$1.0 million investment in Paradigm4 for the six months ended June 30, 2001.

NONCASH COMPENSATION EXPENSE. During 1999, the Company granted options to purchase shares of common stock at exercises prices that were less than the fair market value of the underlying shares of common stock resulting in deferred compensation. During 2000, related to the acquisition of Synet and Global Integrity, the Company issued options to Synet and Global Integrity optionholders in exchange for their Synet and Global Integrity options, respectively. The unvested portion of their Synet and Global Integrity options resulted in deferred compensation. These transactions result in noncash compensation expense over the period that the specific options vest. During the six months ended June 30, 2001 and 2000, the Company recorded approximately \$218,000 and \$38,000, respectively, of noncash compensation expenses related to these options.

OTHER INCOME (EXPENSE). Other income decreased to \$1.7 million in the six months ended June 30, 2001 from \$3.2 million in the six months ended June 30, 2000. This decrease was primarily due to a decrease in interest income as a result of the utilization of cash and cash equivalents to fund current operating needs, the Synet and Global Integrity acquisitions, and a general decline in interest



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rates.

INCOME TAXES. For the six months ended June 30, 2001 the benefit for income taxes was fully offset by valuation allowances. For the six months ended June 30, 2000, the income tax provision was \$2.1 million on pre-tax income of approximately \$4.8 million. The difference in the effective tax rates relates to the provision for a valuation allowance against net operating losses and an increase in expenses not deductible for tax purposes.

LIQUIDITY AND CAPITAL RESOURCES. Since inception, we have financed our operations through borrowings under short-term credit facilities, the sale of equity securities and cash flows from operations. As of June 30, 2001, we had approximately \$59.0 million in cash and cash equivalents and \$2.0 million in marketable securities.

Net cash used in operating activities was \$17.4 million for the six months ended June 30, 2001 due to losses generated in operations and an increase in accrued expenses.

Net cash used in investing activities was \$5.3 million for the six months ended June 30, 2001. Cash used in investing activities resulted from capital expenditures of approximately \$5.1 million and adjustments to purchase

price of \$2.0 million as a result of the acquisition plan. Capital expenditures consisted of \$1.2 million of costs incurred in connection with the development of software to be used for internal purposes and \$3.9 million related to purchases of computer equipment in connection with the expansion of our operations in Germany and the continued investment in our infrastructure.

Cash provided by financing activities was \$1.7 million for the six months ended June 30, 2001. Cash provided by financing activities resulted from the receipt of proceeds from the exercise of options and the sale of stock in connection with the Company's Employee Stock Purchase Plan.

We have a demand loan facility, secured by a lien on all of our assets, under which we may borrow up to the lesser of \$10.0 million or 80.0% of our accounts receivable. Amounts outstanding under the facility bear interest at the lender's base rate which was 6.75% as of June 30, 2001. As of June 30, 2001, there were no amounts outstanding under the facility.

We believe that our existing cash, cash equivalents and marketable securities will be sufficient to meet our anticipated needs for working capital and capital expenditures at least for the next twelve months. If cash generated from operations is insufficient to satisfy our liquidity requirements, we may seek to sell additional equity or debt securities or to obtain a credit facility. The sale of additional equity or convertible debt securities could result in dilution to our stockholders. The incurrence of indebtedness would result in increased fixed obligations and could result in operating covenants that would restrict our operations. We cannot assure you that financing will be available in amounts or on terms acceptable to us, if at all.

### RISK FACTORS

An investment in our company involves a high degree of risk. You should carefully consider the risks described below before you decide to buy our common stock. If any of the following risks actually occur, our business, results of operations or financial condition would likely suffer. In this case, the trading

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price of our common stock could decline.

### Risks Related to Our Financial Condition and Business Model

Our limited operating history, particularly in light of our recent growth, makes it difficult for you to evaluate our business and to predict our future success. We commenced operations in February 1995 and therefore have only a limited operating history for you to evaluate our business. Because of our limited operating history, recent growth and the fact that many of our competitors have longer operating histories, we believe that the prediction of our future success is difficult. You should evaluate our chances of financial and operational success in light of the risks, uncertainties, expenses, delays and difficulties associated with operating a new business, many of which are beyond our control. You should not rely on our historical results of operations as indications of future performance. The uncertainty of our future performance and the uncertainties of our operating in a new and expanding market increase the risk that the value of your investment will decline.

Adverse market conditions, particularly those affecting the professional services industry, may impair our operating results.

Our results depend to a large extent on market conditions affecting the technology industry in general and the telecommunications and enterprise sectors in particular. Adverse market conditions in the sectors in which we operate could delay buying decisions or cause projects to be deferred, reduced in scope or discontinued. These sectors have experienced a drastic downturn in the past twelve months. If market conditions and corporate spending continue to worsen in these sectors, our operating results will continue to suffer.

Because most of our revenues are generated from a small number of clients, our revenues are difficult to predict and the loss of one client could significantly reduce our revenues.

During the six months ended June 30, 2001, BellSouth Corporation accounted for 19.1% of our revenues. Our five largest clients accounted for 41.6% of our revenues for the six months ended June 30, 2001. For the year ended December 31, 2000, our five largest clients accounted for 37.8% of our revenues. If one of our major clients discontinues or significantly reduces the use of our services, we may not generate sufficient revenues to offset this loss of revenues and our net loss will increase. In addition, the non-payment or late payment of amounts due from a major client could adversely affect us. As of June 30, 2001, the accounts receivable from BellSouth Corporation was approximately \$3.3 million, which related to work performed in February 2001 through June 2001.

Our clients may terminate their contracts with us on short notice.

Our services are often delivered pursuant to short-term arrangements and most clients can reduce or cancel their contracts for our services without penalty and with little or no notice. If a major client or a number of small clients terminate our contracts or significantly reduce or modify their business relationships with us, we may not be able to replace the shortfall in revenues. Consequently, you should not predict or anticipate our future revenues based upon the number of clients we have currently or the number and size of our existing projects.

Our operating results may vary from quarter to quarter in future periods, and as a result, we may fail to meet the expectations of our investors and analysts, which may cause our stock price to fluctuate or decline.

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Our operating results have varied from quarter to quarter. Our operating results may continue to vary as a result of a variety of factors. These factors include:

- o the loss of key employees;
  - o the development and introduction of new service offerings;
  - o reductions in our billing rates;
  - o market conditions in the sectors in which we operate;
  - o the miscalculation of resources required to complete new or ongoing projects;
  - o the utilization of our workforce;
  - o the ability of our clients to meet their payments obligations to us;
- and
- o the timing and extent of training.

Many of these factors are beyond our control. Accordingly, you should not rely on quarter-to-quarter comparisons of our results of operations as an indication of our future performance. In addition, our operating results may be below the expectations of public market analysts or investors in some future quarter. If this occurs, the price of our common stock is likely to decline.

We derive a substantial portion of our revenues from fixed-price projects, under which we assume greater financial risk if we fail to accurately estimate the costs of the projects

We derive a substantial portion of our revenues from fixed-price projects. For the six months ended June 30, 2001 and the year ended December 31, 2000, fixed-price projects accounted for 48.5% and 43.2% of our revenue, respectively. We assume greater financial risks on a fixed-price project than on a time-and-expense based project. If we miscalculate the resources or time we need for these fixed-price projects, the costs of completing these projects may exceed the price, which could result in a loss on the project and a decrease in net income. Further, the average size of our contracts has increased in recent quarters, resulting in a corresponding increase in our exposure to the financial risks of fixed-price engagements. We recognize revenues from fixed-price projects based on our estimate of the percentage of each project completed in a reporting period. To the extent our estimates are inaccurate, the revenues and operating profits, if any, that we report for periods during which we are working on a fixed-price project may not accurately reflect the final results of the project and we would be required to record an expense for these periods equal to the amount by which our revenues were previously overstated.

Our operating results may fluctuate due to seasonal factors which could result in greater than expected losses

Our results of operations may experience seasonal fluctuations as businesses typically spend less on network management services during the summer and year-end vacation and holiday periods. Additionally, as a large number of our employees take vacation during these periods, our utilization rates during these periods tend to be lower, which reduces our margins and operating income.

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Accordingly, we may report greater than expected losses for these periods.

Our long sales cycle makes our revenues difficult to predict and could cause our quarterly operating results to be below the expectations of public market analysts and investors

The timing of our revenues is difficult to predict because of the length and variance of the time required to complete a sale. This unpredictability is often compounded by uncertain market conditions. Before hiring us for a project, our clients often undertake an extensive review process and may require approval at various levels within their organization. Any delay due to a long sales cycle could reduce our revenues for a quarter and cause our quarterly operating results to be below the expectations of public market analysts or investors. If this occurs, the price of our common stock is likely to decline.

We may need to raise additional capital to grow our business, which we may not be able to do

Our future liquidity and capital requirements are difficult to predict because they depend on numerous factors, including the success of our existing and new service offerings and competing technological and market developments. As a result, we may not be able to generate sufficient cash from our operations to meet additional working capital requirements, support additional capital expenditures or take advantage of acquisition opportunities. Accordingly, we may need to raise additional capital in the future. Our ability to obtain additional financing will be subject to a number of factors, including market conditions, our operating performance and investor sentiment. These factors may make the timing, amount, terms and conditions of additional financing unattractive for us. If we are unable to raise additional funds when needed, our ability to operate and grow our business could be impeded.

### Risks Related to Our Strategy and Market

We may have difficulty managing our operations, which may harm our business

A key part of our strategy is to grow our business; however, our rapid growth has placed a significant strain on our managerial and operational resources. From January 1, 1997 to June 30, 2001, our staff increased from approximately 123 to approximately 596 employees. Since such time, as a result of market conditions and other factors, we have decreased our staff to 539 employees as of August 1, 2001. As a result of this reduction, the remaining employees have been charged with additional responsibilities. To manage our growth, we must continue to improve our financial and management controls, reporting systems and procedures, and expand and train our work force. We may not be able to do so successfully.

Our management team has experienced significant turnover which could interrupt our business and adversely affect our growth

Our future success depends, in significant part, upon the continued service and performance of our senior management and other key personnel. Andrew Zimmerman has recently been appointed our Chief Executive Officer, and our President has recently resigned. In addition, in connection with our recent reduction in staff, many members of our senior management team have either departed, or been redeployed and given new responsibilities. If the restructuring of our senior management team does not lead to the results we expect, our ability to effectively deliver our services, manage our company, and carry out our business plan may be impaired.

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We may not be able to hire and retain qualified network systems consultants which could affect our ability to compete effectively

Our continued success depends on our ability to identify, hire, train and retain highly qualified network management consultants. These individuals are in high demand and we may not be able to attract and retain the number of highly qualified consultants that we need. If we cannot retain, attract and hire the necessary consultants, our ability to grow, complete existing projects and bid for new projects will be adversely affected.

Competition in the network consulting industry is intense, and therefore we may lose projects to our competitors

Our market is intensely competitive, highly fragmented and subject to rapid technological change. We expect competition to intensify and increase over time. We may lose projects to our competitors, which could adversely affect our business, results of operations and financial condition. In addition, competition could result in lower billing rates and gross margins and could require us to increase our spending on sales and marketing.

We face competition from systems integrators, value added resellers, network services firms, telecommunications providers, and network equipment and computer systems vendors. These competitors may be able to respond more quickly to new or emerging technologies and changes in client requirements or devote greater resources to the expansion of their market share.

Additionally, our competitors have in the past and may in the future form alliances with various network equipment vendors that may give them an advantage in implementing networks using that vendor's equipment.

We also compete with internal information technology departments of current and potential clients. To the extent that current or potential clients decide to satisfy their needs internally, our business will suffer.

Our acquisitions of Synet Service Corporation and Global Integrity Corporation may not result in the benefits we anticipate from a combined company

We recently consummated our acquisition of Synet Service Corporation and Global Integrity Corporation. The integration of Synet and Global Integrity into our operations presents us with significant financial, managerial and operational challenges and may:

- o divert management attention from running our existing business;
- o require us to expend resources integrating different technologies and cultures; and
- o strain our financial reporting systems and procedures.

The acquisitions may not result in the benefits we anticipate from the combined company and may underperform relative to our expectations, including with respect to increased business opportunities and economies of scale, and the retention of personnel from the acquired companies. Moreover, the acquisitions will require us to amortize additional goodwill in our financial statements, leading to an adverse effect on our operating results.

If we are unable to find suitable acquisition candidates, our growth could be impeded

A component of our growth strategy is the acquisition of, or investment

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in, complementary businesses, technologies, services or products. Our ability to identify and invest in suitable acquisition and investment candidates on acceptable terms is crucial to this strategy. We may not be able to identify, acquire or make investments in promising acquisition candidates on acceptable terms. Moreover, in pursuing acquisition and investment opportunities, we may be in competition with other companies having similar growth and investment strategies. Competition for these acquisitions or investment targets could also result in increased acquisition or investment prices and a diminished pool of businesses, technologies, services or products available for acquisition or investment.

Our acquisition strategy could have an adverse effect on client satisfaction and our operating results

Acquisitions, including those already consummated, involve a number of risks, including:

- o adverse effects on our reported operating results due to accounting charges associated with acquisitions;
- o increased expenses, including compensation expense resulting from newly hired employees; and
- o potential disputes with the sellers of acquired businesses, technologies, services or products.

Client dissatisfaction or performance problems with an acquired business, technology, service or product could also have a material adverse impact on our reputation as a whole. In addition, any acquired business, technology, service or product could significantly underperform relative to our expectations.

Our international expansion efforts, which are a key part of our growth strategy, may not be successful

We expect to expand our international operations and international sales and marketing efforts. In January 1999, we commenced operations in England. In August 1999, we acquired Network Resource Consultants and Company, a network consulting company based in The Netherlands. Additionally, Synet Service Corporation, acquired in October 2000, has a German subsidiary, whose operations we have significantly increased, and Global Integrity Corporation, acquired in December 2000, has existing operations in England and Japan. We have had limited experience in marketing, selling and distributing our services internationally. We may not be able to maintain and expand our international operations or successfully market our services internationally. Failure to do so may negatively affect our business, as well as our ability to grow.

Our business may suffer if we fail to adapt appropriately to the challenges associated with operating internationally

Operating internationally may require us to modify the way we conduct our business and deliver our services in these markets. We anticipate that we will face the following challenges internationally:

- o the burden and expense of complying with a wide variety of foreign laws and regulatory requirements;
- o potentially adverse tax consequences;

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- o longer payment cycles and problems in collecting accounts receivable;
- o technology export and import restrictions or prohibitions;
- o tariffs and other trade barriers;
- o difficulties in staffing and managing foreign operations;
- o cultural and language differences;
- o fluctuations in currency exchange rates; and
- o seasonal reductions in business activity during the summer months in Europe.

If we do not appropriately anticipate changes and adapt our practices to meet these challenges, our growth could be impeded and our results of operations could suffer.

If we do not keep pace with technological changes, our services may become less competitive and our business will suffer

Our market is characterized by rapidly changing technologies, frequent new product and service introductions and evolving industry standards. As a result of the complexities inherent in today's computing environments, we face significant challenges in remaining abreast of such changes and product introductions. If we cannot keep pace with these changes, we will not be able to meet our clients' increasingly sophisticated network management needs and our services will become less competitive.

Our future success will depend on our ability to:

- o keep pace with continuing changes in industry standards, information technology and client preferences;
- o respond effectively to these changes; and
- o develop new services or enhance our existing services.

We may be unable to develop and introduce new services or enhancements to existing services in a timely manner or in response to changing market conditions or client requirements.

If the use of large-scale, complex networks does not continue to grow, we may not be able to successfully increase or maintain our client base and revenues

To date, a majority of our revenues have been from network management services related to large-scale, complex networks. We believe that we will continue to derive a majority of our revenues from providing network design, performance, management and security services. As a result, our future success is highly dependent on the continued growth and acceptance of large-scale, complex computer networks and the continued trend among our clients to use third-party service providers. If the growth of the use of enterprise networks does not continue or declines, our business may not grow and our revenues may decline.

We may not successfully penetrate the managed security services market

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In December 2000, we entered into the managed security services market. This is a new market for us and one in which we have not had significant experience. Entering into this market requires a material financial commitment by us. To date we have made a substantial infrastructure investment in order to serve this market. We cannot assure you that our efforts in this new market will be successful. Accordingly, we may lose some or all of the resources we invest in this new market.

### Risks Related to Intellectual Property Matters and Potential Legal Liability

Unauthorized use of our intellectual property by third parties may damage our brand

We regard our copyrights, trade secrets and other intellectual property as critical to our success. Unauthorized use of our intellectual property by third parties may damage our brand and our reputation. We rely on trademark and copyright law, trade secret protection and confidentiality and/or license and other agreements with our employees, customers, partners and others to protect our intellectual property rights. However, we do not have any patents or patent applications pending and existing trade secret, trademark and copyright laws afford us only limited protection. Despite our precautions, it may be possible for third parties to obtain and use our intellectual property without our authorization. The laws of some foreign countries are also uncertain or do not protect intellectual property rights to the same extent as do the laws of the United States.

We may have to defend against intellectual property infringement claims, which could be expensive and, if we are not successful, could disrupt our business

We cannot be certain that our services, the finished products that we deliver or materials provided to us by our clients for use in our finished products do not or will not infringe valid patents, copyrights, trademarks or other intellectual property rights held by third parties. As a result, we may be subject to legal proceedings and claims from time to time relating to the intellectual property of others in the ordinary course of our business. We may incur substantial expenses in defending against these third-party infringement claims, regardless of their merit. Successful infringement claims against us may result in substantial monetary liability or may materially disrupt the conduct of our business.

Because our services are often critical to our clients' operations, we may be subject to significant claims if our services do not meet our clients' expectations

Many of our projects are critical to the operations of our clients' businesses. If we cannot complete these projects to our clients' expectations, we could materially harm our clients' operations. This could damage our reputation, subject us to increased risk of litigation or result in our having to provide additional services to a client at no charge. Although we carry general liability insurance coverage, our insurance may not cover all potential claims to which we are exposed or may not be adequate to indemnify us for all liability that may be imposed.

Our stock price is likely to be highly volatile and could drop unexpectedly

The market price of our common stock is highly volatile, has fluctuated



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substantially and may continue to do so. As a result, investors in our common stock may experience a decrease in the value of their common stock regardless of our operating performance or prospects. In addition, the stock market has, from time to time, experienced significant price and volume fluctuations that have affected the market prices for the securities of technology companies. In the past, following periods of volatility in the market price of a particular company's securities, securities class action litigation was often brought against that company. Many technology-related companies have been subject to this type of litigation. We may also become involved in this type of litigation. Litigation is often expensive and diverts management's attention and resources.

We are controlled by a small group of our existing stockholders, whose interests may differ from other stockholders

Our directors, executive officers and affiliates currently beneficially own approximately 45% of the outstanding shares of our common stock. Accordingly, these stockholders will have significant influence in determining the outcome of any corporate transaction or other matter submitted to the stockholders for approval, including mergers, acquisitions, consolidations and the sale of all or substantially all of our assets, and also the power to prevent or cause a change in control. The interests of these stockholders may differ from the interests of the other stockholders.

Our charter documents and Delaware law may inhibit a takeover that stockholders may consider favorable

Provisions in our charter and bylaws may have the effect of delaying or preventing a change of control or changes in our management that stockholders consider favorable or beneficial. If a change of control or change in management is delayed or prevented, the market price of our common stock could decline.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

#### Currency Rate Fluctuations.

Our results of operations, financial position and cash flows are not materially affected by changes in the relative values of non-U.S. currencies to the U.S. dollar. We do not use derivative financial instruments to limit our foreign currency risk exposure.

#### Market Risk.

Our accounts receivable are subject, in the normal course of business, to collection risks. We regularly assess these risks and have established policies and business practices to protect against the adverse effects of collection risks. As a result, we do not anticipate any material losses in this area.

#### Interest Rate Risks.

We do not currently have any outstanding indebtedness. In addition, our investments are classified as cash and cash equivalents with original maturities of three months or less. Therefore, we are not exposed to material market risk arising from interest rate changes, nor do such changes affect the value of investments as recorded by us.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

Except as set forth below, we are not a party to any material legal proceedings.

On October 29, 1999, Art Eckert ("Plaintiff") filed an action against the Company in which he alleged that the Company was in breach of an employment agreement between Plaintiff and the Company. Plaintiff also alleged that the

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Company fraudulently induced Plaintiff to enter into this purported employment agreement. Plaintiff seeks to recover damages in excess of \$3.2 million with respect to the claim for breach of contract, and damages in excess of

\$6.0 million with respect to the claim for fraudulent inducement. The Company filed a motion to dismiss the claim for fraudulent inducement on December 13, 1999. Plaintiff amended the complaint, essentially adding allegations with respect to the claim for fraudulent inducement, and opposing the Company's motion.

By Decision and Order filed on July 11, 2000, Judge S. Barrett Hickman, in New York Supreme Court, Putnam County, denied the Company's motion to dismiss the claim for fraudulent inducement. The case is in the discovery phase and Predictive intends to defend it vigorously.

By Decision and Order dated July 16, 2001, Judge Hickman denied Plaintiff's motion to amend his complaint to add a new cause of action for breach of an implied covenant of good faith and fair dealing.

This matter is set for trial on May 6, 2002.

### ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

On October 27, 1999, the SEC declared effective the Registration Statement on Form S-1, SEC Registration Number 333-84045 for our public offering of common stock in the United States (the "Offering"). We realized net proceeds of approximately \$67.0 million from the Offering. Since that time we have used the proceeds for the following: \$11.1 million for the acquisition of Synet; \$33.3 million for the acquisition of Global Integrity; and \$21.1 million to fund current operating needs.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

NONE

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

We held our 2001 Annual Meeting of Stockholders on May 22, 2000. At that meeting, the stockholders approved the following proposals: (i) the election of Peter L. Bloom, Eric Meyer and William W. Wyman as Class II directors to serve on the Board of Directors, (ii) the ratification of the Board of Directors' decision to select Arthur Andersen LLP as our independent public accountants for the year ending December 31, 2001 and (iii) the approval of an amendment to our 1999 Stock Incentive Plan to increase the number of shares of common stock reserved for issuance under the plan by 14,000,000 shares to an aggregate of 21,004,637 shares.

There were 31,569,766 votes cast for, 40,386 votes cast against and 0 abstentions in connection with the election of Peter L. Bloom as a Class II Director. There were 31,362,682 votes cast for, 247,470 votes cast against and 0 abstentions in connection with the election of Eric Meyer as a Class II Director. There were 27,467,585 votes cast for, 4,142,567 votes cast against and 0 abstentions in connection with the election of William W. Wyman as a Class II Director. The remainder of our Board of Directors remains as previously reported. There were 31,552,721 votes cast for, 55,671 votes cast against and 1,760 abstentions in connection with ratification of the Board of Director's decision to select Arthur Andersen LLP as our independent public accountants for the year ending December 31, 2001. There were 17,741,501 votes cast for, 8,241,071 votes cast

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against and 59,611 abstentions in connection with the approval of an amendment to our 1999 Stock Incentive Plan to increase the number of shares of common stock reserved for issuance under the plan by 14,000,000 shares to an aggregate of 21,004,637 shares.

ITEM 5. OTHER INFORMATION  
NONE

ITEM 6. EXHIBITS AND REPORT ON FORM 8-K

(a) The following exhibit is filed as part of this report:

10.1 Employment Agreement, dated as of June 15, 2001, by and between the Registrant and Andrew Zimmerman.

(b) The Company filed two reports on Form 8-K during the first quarter ended June 30, 2001. Information regarding the items reported on is as follows:

April 3, 2001

The Company announced that Ronald G. Pettengill had resigned as Chairman and Chief Executive Officer of the Company.

June 28, 2001

The Company announced that Andrew Zimmerman has been elected Chief Executive Officer of the Company.

ITEM 7. SIGNATURES

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

PREDICTIVE SYSTEMS, INC.

(Registrant)

Date: August 14, 2001 /s/ ANDREW ZIMMERMAN

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Name: Andrew Zimmerman

Title: Chief Executive Officer  
(principal executive officer)

Date: August 14, 2001 /s/ GERARD E. DORSEY

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Name: Gerard E. Dorsey  
Title: Chief Financial Officer  
(principal accounting and financial officer)