SMARTFORCE PUBLIC LTD CO
Form 10-Q
May 15, 2001

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 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 MARCH 31, 2001

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

FOR THE TRANSITION PERIOD FROM ________ TO ________

Commission File Number: 0-25674

SMARTFORCE PUBLIC LIMITED COMPANY
(Exact name of registrant as specified in its charter)

Republic of Ireland	Not Applicable
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

900 CHESAPEAKE DRIVE
REDWOOD CITY, CALIFORNIA 94063
(Address of principal executive offices, including zip code)

(650) 817-5900
(Registrant's telephone number, including area code)

Indicate by check mark whether 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 Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past ninety (90) days.

Yes [X] No [ ]

The number of American Depositary Shares ("ADSs") (issued or issuable in exchange for Registrant's outstanding Ordinary Shares) outstanding as of April 30, 2001 was 52,588,830.

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PART I FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

SMARTFORCE PUBLIC LIMITED COMPANY

CONDENSED CONSOLIDATED BALANCE SHEETS
(dollars in thousands)

	December 31, 2000	March 31, 2001
ASSETS		
CURRENT ASSETS		
Cash	$ 65,412	$ 48,442
Short-term investments	42,545	42,984
Accounts receivable, net	76,458	81,472
Inventories	369	306

Recoverable and deferred tax assets, net	2,517	2,326
Prepaid expenses	12,467	19,899
Total current assets	199,768	195,429
Intangible assets	73,194	70,606
Property and equipment, net	29,388	30,659
Investment	3,616	3,616
Deferred tax assets	--	182
Other assets	28,817	33,049
Total assets	$ 334,783	$ 333,541
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 6,961	$ 2,247
Accrued payroll and related expenses	9,926	7,465
Other accrued liabilities	22,118	20,225
Deferred revenues	48,381	50,043
Total current liabilities	87,386	79,980
NON-CURRENT LIABILITIES		
Minority equity interest	307	307
Other liabilities	1,452	1,440
Total non-current liabilities	1,759	1,747
SHAREHOLDERS' EQUITY		
Ordinary Shares, IR9.375p par value: 120,000,000 shares authorized at December 31, 2000 and March 31, 2001; issued and outstanding: 51,970,046 and 51,944,277 shares at December 31, 2000 and 52,568,499 and 52,542,730 at March 30, 2001,respectively	7,656	7,715
Additional paid-in capital	232,640	239,418
Accumulated profit	6,191	6,137
Capital redemption reserve	296	296
Other comprehensive income	(1,143)	(1,750)
Treasury stock	(2)	(2)
Total shareholders' equity	245,638	251,814
Total liabilities and shareholders' equity	$ 334,783	$ 333,541

See notes to condensed consolidated financial statements

Note: The balance sheet does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

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SMARTFORCE PUBLIC LIMITED COMPANY

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(dollars in thousands, except per share amounts)

	Three months ended March 31, 2000	2001
Revenues	$ 28,534	$ 61,284
Cost of revenues	4,667	9,737
Gross profit	23,867	51,547
Operating expenses:		
Research and development	8,500	12,425
Sales and marketing	23,193	31,710
General and administrative	4,464	5,674
Amortization of acquired intangibles	1,717	2,323
Total operating expenses	37,874	52,132
Loss from operations	(14,007)	(585)
Other income, net	1,154	842
Income /(loss) before provision for income taxes	(12,853)	257
Benefit/(provision) for income taxes	1,114	(310)
Net loss	$(11,739)	$ (53)
Net loss per share - Basic	$ (0.23)	$ (0.00)
Shares used in computing net loss per share - Basic	50,353	52,334
Net loss per share - Diluted	$ (0.23)	$ (0.00)
Shares used in computing net loss per share - Diluted	50,353	52,334

See notes to condensed consolidated financial statements

Note: The statement of operations does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

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SMARTFORCE PUBLIC LIMITED COMPANY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in thousands)

	Three months e March 31
	2000

CASH FLOWS FROM OPERATING ACTIVITIES	
Net loss	$(11,739)
Adjustments to reconcile net loss to net cash used by operating activities:	
Depreciation and amortization	4,681
Accrued interest on short-term investments	(575)
Changes in operating assets and liabilities:	
Accounts receivable	15,251
Inventories	(249)
Deferred tax assets	(1,101)
Prepaid expenses and other assets	(5,595)
Accounts payable	846
Accrued payroll and related expenses and other accrued liabilities	(7,145)
Deferred revenues	2,941
Net cash used by operating activities	(2,685)
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchases of property and equipment	(3,828)
Payment to acquire assets of Advanced Education Systems	(271)
Proceeds from sale of short-term investments	43,000
Payment to acquire investments	(50)
Payments to acquire short-term investments	(44,071)
Net cash used in investing activities	(5,220)
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds from issuance of ordinary shares, net	3,748
Net cash provided by financing activities	3,748
Effect of exchange rate changes on cash and cash equivalents	367
Net decrease in cash and cash equivalents	(3,790)
Cash and cash equivalents at beginning of period	69,260
Cash and cash equivalents at end of period	$ 65,470

See notes to condensed consolidated financial statements

Note: The statements of cash flows does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

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SMARTFORCE PUBLIC LIMITED COMPANY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. INTERIM CONSOLIDATED FINANCIAL STATEMENTS

These interim unaudited condensed and consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements. However, the Company believes that the disclosures are adequate to ensure that the information presented is not misleading. The accompanying interim financial statements should be read in conjunction with the financial statements and related notes included in our Annual Report to Shareholders as amended on Form 10-K/A for the year ended December 31, 2000. In the opinion of management, all adjustments (consisting of normal recurring accruals), considered necessary for a fair presentation of financial position, results of operations and cash flows at the dates and for the periods presented have been included. The results of operations for the periods presented are not necessarily indicative of the results expected for the full financial year or for any future period.

NOTE 2. COMPUTATION OF NET INCOME PER SHARE

Basic net income per share is calculated using the weighted average number of our ordinary shares outstanding during the period including the issuance of ordinary shares as a result of pooling of interests, at the beginning of the earliest period presented or subsequent date of incorporation of the pooled entity as applicable. Diluted net income per share is similarly calculated using the combined weighted average number of ordinary and dilutive potential ordinary shares, (as determined using the treasury stock method), such as shares issuable pursuant to the exercise of options outstanding including the issuance of ordinary and dilutive potential ordinary shares as a result of pooling of interests.

The following table sets forth the computation of basic and diluted net loss per share:

	Three Months Ended March 31,	
	2000	2001
(dollars in thousands, except per share amounts)		
Numerator:		
Numerator for basic and diluted net loss per share - loss available to common shareholders	$(11,739)	$ (53)
Denominator:		
Denominator for basic net loss per share - weighted average shares	50,353	52,334
Effect of dilutive securities:		
Employee stock options	--	--
Denominator for diluted net loss per share - adjusted weighted average shares and assumed conversion	50,353	52,334
Basic net loss per share	$ (0.23)	$ (0.00)
Diluted net loss per share	$ (0.23)	$ (0.00)

NOTE 3. COMPREHENSIVE INCOME

Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income," establishes rules for the reporting and display of comprehensive income and its components.

The following table sets forth the calculation of comprehensive income on an interim basis:

(dollars in thousands)	Three months ended March 31, 2000	2001
Net loss	$(11,739)	$ (53)
Other Comprehensive loss		
Cumulative effect of change in accounting Principle (SFAS 133)	--	3,703
Movement on cash flow hedges	--	(3,208)
Foreign currency translation adjustment	(1)	(1,102)
Total Comprehensive loss	$(11,740)	$ (660)

NOTE 4. SEGMENT GEOGRAPHIC AND CUSTOMER INFORMATION

The Company presents financial information for its three reportable operating segments: Americas, Europe Middle East Africa ("EMEA") and Ireland. The Americas and EMEA segments are sales operations and Ireland is the Company's Research and Development operation.

The Company and its subsidiaries operate in one industry segment, the development and marketing of e-learning solutions. Operations outside of Ireland consist principally of sales and marketing.

The Company's products are developed in Ireland and sold to the Company's distribution subsidiaries in other geographic segments. These inter segment revenues are determined on arms length bases pursuant to which a fair profit is earned by the Irish development subsidiary and which is designed to comply with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators. All such inter segment revenues and costs of revenues are eliminated on consolidation.

The Company's Chief Operating Decision Maker ("CODM"), the Company's Chairman, President and CEO, allocates resources and evaluates performance based on a measure of segment profit or loss from operations. The accounting policies of the reportable segments are the same as described in the summary of significant accounting policies. The Company's CODM does not view segment results below operating profit (loss), therefore, net interest income, other income and the provision for income taxes are not broken out by segment below. The Company does not account for nor report to the CODM its assets or capital expenditures by segment, thus asset information is not provided on a segment basis.

A summary of the segment financial information reported to the CODM is as follows:

	QUARTER ENDED MARCH 31, 2001			
	AMERICAS	EMEA	IRELAND	ALL OTHER
	(dollars in thousands)			
Revenues--External	$ 44,758	$ 8,066	$ 6,399	$ 2,061
Inter segment Revenues	--	--	25,645	--
Depreciation and Amortization	4,002	69	1,792	230
Segment Operating Income/(Loss)	(12,034)	(808)	15,427	(3,170)

	QUARTER ENDED MARCH 31, 2001			
	AMERICAS	EMEA	IRELAND	ALL OTHER
	(dollars in thousands)			
Revenues--External	$ 22,764	$ 4,399	$ 82	$ 1,289
Inter segment Revenues	--	--	13,624	--
Depreciation and Amortization	2,011	108	829	1,733
Segment Operating Income/(Loss)	(12,305)	(1,690)	2,849	(2,861)

Revenues from external customers, based on the location of the customer, are categorized by geographical areas as follows:

	QUARTER ENDED MARCH 31,	
	2000	2001
	(dollars in thousands)	
Revenues		
Ireland	$ 1,061	$ 1,008
United States	18,285	42,546
United Kingdom	4,909	6,710
Other countries	4,279	11,020
Total	$28,534	$61,284

Long-Lived assets are those assets that can be directly associated with a particular geographic area. These assets are categorized by geographical areas as follows:

	MARCH 31, 2000	MARCH 31, 2001
	(dollars in thousands)	
Long-Lived Assets		
Ireland	$ 13,743	$ 63,677
United States	38,661	56,930
Other countries	65,519	17,323
Total	$117,923	$137,930

The Company regards its e-learning solutions as homogenous products and services.

NOTE 5. RECENT ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board issued Statement No. 133 "Accounting for Derivative Instruments and Hedging Activities" ("Statement 133") in June 1998. Statement 133, which requires all derivative instruments to be recognized as either assets or liabilities on the balance sheet at their fair value, provides a comprehensive and consistent standard for the recognition and measurement of derivatives and hedging activities. As amended, this statement is effective for fiscal years beginning after June 15, 2000. The Company applied the new rules prospectively to transactions beginning in the first quarter of 2001. The cumulative effect of the change in accounting principle due to the adoption of Statement 133 resulted in the recognition of a net loss of $170,811 in the income statement and a net gain of $3.7 million in other comprehensive income. During the three months ended March 31, 2001, the amount recorded in earnings relating to cash flow ineffectiveness was $159,540. During the three months ended March 31, 2001, we recorded a net loss of $3.2 million in respect of the movement on the cash flow hedges held at March 31, 2001.

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

OVERVIEW

We provide comprehensive, integrated e-Learning solutions that help businesses deploy knowledge across their extended enterprise of employees, customers, suppliers, distributors and other business partners. Our hosted e-Learning platform provides access to a comprehensive offering of learning events and resources. Our platform allows organizations to customize their e-Learning environment to meet their corporate objectives and to train their employees and business partners quickly, efficiently and effectively. Our e-Learning solutions also provide individuals access to dynamic, continuously updated learning events so they can personalize their e-Learning environment to meet their specific educational and career objectives. Our platform also includes a learning management system to help managers track and assess the effectiveness of their training initiatives as well as a variety of assessment and feedback tools to help users better understand their educational progress.

Prior to 2000, we derived our revenues primarily under a software license model pursuant to license agreements under which customers license usage of

delivered software products for a period of one, two or three years. On each anniversary date during the term of multi-year license agreements, customers have been generally allowed to exchange any or all of the licensed products for an equivalent number of alternative products within our library. The first year license fee has historically been generally recognized as revenue at the time of delivery of all products, provided a signed contract or other persuasive evidence of an arrangement exists, our fees are fixed or determinable and collections of accounts receivable are probable. Subsequent annual license fees under the software license model are recognized on each anniversary date, provided a signed contract or other persuasive evidence of an arrangement exists, our fees are fixed or determinable and collections of accounts receivable are probable. Revenues from license agreements providing product exchange rights other than annually during the term of the agreement are deferred and recognized ratably over the contract period.

During 2000 we migrated the majority of our business from the software license model to an e-Learning rental model, under which we rent to our customers access to our learning environment for a certain period of time, such as one, two or three years. Under the e-Learning rental model, revenue derived from e-Learning rental agreements is generally deferred and recognized ratably over the term of the relevant agreement, rather than annually in advance as was the case under the historical software license model, provided a signed contract or other persuasive evidence of an arrangement exists, our fees are fixed or determinable and collections of accounts receivable are probable.

The cost of satisfying any post contract support, or PCS, is accrued at the time revenue is recognized, as PCS fees are included in the annual license fee, the estimated cost of providing PCS during the agreements is insignificant and unspecified upgrades or enhancements offered have been and are expected to be minimal and infrequent. For multi-element agreements where vendor specific objective evidence exists to allocate the total fee among the various elements of the agreement each element is recognized as appropriate. Where no such vendor specific objective evidence exists revenue is recognized ratably over the life of the agreement.

In addition, we derive revenues from sales of our products, which are recognized upon shipment, net of allowances for estimated future returns and for excess quantities in distribution channels, provided persuasive evidence of an arrangement exists, our fees are fixed or determinable, and collections of accounts receivable are probable.

Our e-Learning agreements may have other accounting and operating model consequences that are materially different from our software licensing structure. For example, in the second quarter of 1999, we entered into an agreement with a major customer to provide an outsourced virtual university for technical education. Under the contract, the customer has licensed educational software from us, and has also contracted for professional services, management

fees, on-line mentoring services and certain other items. In addition, the agreement provides for the reselling by us of third parties' instructor-led training to the customer. Revenues from the non-software licenses component of this agreement, which represent a substantial majority of the firmly contracted amount with the customer and all of the potential incremental revenues over the firmly contracted amount, will generally be recognized as services are performed, which will have the effect of deferring revenue. Since that time an increasing number of customers, including most of our largest customers, have purchased a variety of different products and services from us, with different revenue recognition and operating model profiles. We expect to continue to

experience increasing numbers of customers who fit this profile in the future. 1

Moreover, the gross margins associated with the non-software license and non-rental components (and in particular the resale of third-party instructor-led training) are expected to be substantially lower than the gross margins typically associated with our software license agreements. 2

In recent years, we have entered into several content development and marketing alliances with key vendors of technology software under which we develop e-Learning content for training on specific products. Under certain of our development and marketing alliances, our partners have agreed to fund certain product development costs. We recognize such funding as revenues on a percentage of completion basis, and the costs associated with such revenues are reflected as cost of revenues. These agreements have the effect of shifting expenses associated with developing certain new products from research and development to cost of revenues. We expect that cost of revenues may fluctuate from period to period in the future based upon many factors. We do not expect funding from development partners to contribute significantly to revenues in future years.

RECENT DEVELOPMENTS

ACQUISITIONS

On April 2, 2001, we acquired icGlobal, providers of industry-acclaimed Learning Management System (LMS) software. The LMS software enables global organizations, content providers and institutions to develop, track and manage all e-Learning events and instructor-led-training, empowering administrators to manage their entire learning environment. We issued to the shareholders of icGlobal the right to acquire 100,000 ADSs as consideration for the outstanding securities of icGlobal. The transaction will be accounted for under the purchase method of accounting in accordance with generally accepted accounting principles.

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1 This paragraph consists of forward-looking statements reflecting our current expectations. Our actual future performance may differ materially from our current expectations. You are strongly encouraged to review the section entitled "Additional Risk Factors That Could Affect Operating Results" commencing on page 15 and discussions elsewhere in this Quarterly Report on Form 10-Q of the factors that could affect future performance.

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The combination of the operation of icGlobal with our operations will result in an increase in our research and development expenses. In addition, the amortization of goodwill and any intangible assets acquired as part of icGlobal, will negatively impact the results of operations in future periods. Unanticipated contingencies that would substantially increase the costs of combining the operation of icGlobal with us may occur. 3

RESULTS OF OPERATIONS

The following table sets forth certain consolidated statements of

operations data as a percentage of revenues:

	Three months ended March 31, 2000	2001
Revenues	100%	100%
Cost of revenues	16.4	15.9
Gross Profit	83.6	84.1
Operating expenses:		
Research and development	29.8	20.3
Sales and marketing	81.3	51.7
General and administrative	15.6	9.3
Amortization of acquired intangibles	6.0	3.8
Total operating expenses	132.7	85.1
Loss from operations	(49.1)	(1.0)
Other income, net	4.1	1.4
(Loss)/income before provision for income taxes	(45.0)	0.4
Benefit/(provision) for income taxes	3.9	(0.5)
Net loss	(41.1)%	(0.1)%

REVENUES

Revenues increased to $61.3 million in the three months ended March 31, 2001 from $28.5 million in the three months ended March 31, 2000.

Following the introduction of SmartForce e-Learning in January 2000 we commenced the migration of our business from the software license model to an e-Learning rental model where revenue is generally deferred and recognized ratably over the term of the agreement rather than annually in advance as was the case under the software license model. As a result of the rapid customer adoption of SmartForce e-Learning and the resulting move to an e-Learning rental model in the first quarter of 2000, revenues for that quarter decreased significantly compared to the three months ended March 31, 1999. During 2000 we continued our customer migration to SmartForce e-Learning which resulted in the deferral of revenue from 2000 into 2001. The increase in

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revenues for the three months ended March 31, 2001 as compared to the three months ended March 31, 2000, is primarily attributable to the transition of the majority of our business from the software license model to the e-Learning rental model as well as increased revenue from our e-Learning solutions as a

result of increases in the number of sales and sales related personnel and the expansion of our e-Learning offerings during 2000 and the three months ended March 31, 2001.

Revenues in the United States for the three months ended March 31, 2001 were $42.5 million (or 69% of revenues) compared to $18.3 million (or 64% of revenues) for the three months ended March 31, 2000.

Revenues in the United Kingdom for the three months ended March 31, 2001 were $6.7 million (or 11% of revenues), compared to $4.9 million (or 17% of revenues) for the three months ended March 31, 2001. Revenues in Ireland for the three months ended March 31, 2001 were $1.0 million (or 2% of revenues) compared to $1.0 million (or 4% of revenues) for the three months ended March 31, 2000.

In addition, revenues from outside the United States, United Kingdom and Ireland (principally from Australia, Europe (other than the United Kingdom and Ireland), Canada, Asia, South Africa and the Middle East) for the three months ended March 31, 2001 were $11 million (or 18% of revenues), compared to $4.3 million (or 15% of revenues) for the three months ended March 31, 2000.

Because a significant portion of our business is conducted outside the United States, we are subject to a number of risks associated with doing business in other countries, including risks related to currency fluctuations.

COST OF REVENUES

Cost of revenues includes the cost of materials (such as packaging and documentation), royalties to third parties, the portion of development costs associated with funded development projects, hosting, the cost of providing professional services, fulfillment, shipping and handling costs and the amortization of the cost of purchased products.

Gross margins increased to 84.1% in the three months ended March 31, 2001 from 83.6% in the three months ended March 31, 2000. The higher gross margin for the three months ended March 31, 2001 was attributable to increased revenues in the three months ended March 31, 2001 as compared to the three months ended March 31, 2000, and a certain portion of our cost of revenues being fixed. This increase in gross margin for the three months ended March 31, 2001, as compared to March 31, 2000, was partially offset by a modest increase in the proportion of revenues derived from services.

We expect that cost of revenues may fluctuate from period to period in the future based upon many factors, including the rate at which we continue to migrate our customers to our e-Learning solutions, the revenue mix (including between software, services and partner's products) and the timing of expenses associated with development and marketing alliances. In particular, we expect that services may represent an increasing proportion of our revenues. 4

OPERATING EXPENSES

Our operating expenses increased in dollar terms in the three months ended March 31, 2001 as compared to the three months ended March 31, 2000, primarily as a result of the growth in our business and our ongoing investments in our e-learning solutions. Operating expenses as a percentage of revenues decreased in the three months ended March 31, 2001 as compared to the three months ended March 31, 2000, primarily as a result of the rapid adoption of our e-learning solutions in the first quarter of 2000 which resulted in the deferral of revenues into future periods and consequently a significant increase in operating expenses as a percentage of revenues.

RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses consist primarily of salaries and benefits, related overhead costs, travel expenses and fees paid to outside consultants.

Research and development expenses increased in the three months ended March 31, 2001 to $12.4 million from $8.5 million in the three months ended March 31, 2000. The increase in research and development in the three months ended March 31, 2001 as compared to the three months ended March 31, 2000 is due primarily to the hiring of additional research and development personnel and the continued development of our e3 application architecture, all of which are required to further develop and expand our e-Learning solutions.

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We believe that significant investment in research and development is required to build-out our e-Learning infrastructure and to remain competitive in the information technology and business skills education and training market. We therefore expect research and development expenses to increase in future periods. 5

Software development costs are accounted for in accordance with Statement of Financial Accounting Standards No. 86, under which we are required to capitalize software development costs after technological feasibility has been established. To date, development costs after establishment of technological feasibility have been immaterial, and all software development costs have been expensed as incurred.

SALES AND MARKETING EXPENSES

Sales and marketing expenses consist primarily of salaries and commissions, travel expenses, advertising and promotional expenses and related overhead costs.

These expenses increased to $31.7 million in the three months ended March 31, 2001 from $23.2 million for the three months ended March 31, 2000. The increase was primarily attributable to increases in the number of sales and marketing personnel to accommodate the growth in sales, higher absolute dollar commission costs associated with increased revenues, and increases in advertising and promotional expenses to build the SmartForce brand and market our e-Learning solutions. We expect to continue to increase sales and marketing expenses in the future to build the SmartForce brand and to support an increase in our sales force and expansion of our marketing efforts. 6

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses consist primarily of salaries and benefits, travel expenses, legal, accounting and consulting fees and related overhead costs for administrative officers and support personnel.

General and administrative expenses increased to $5.7 million for the three months ended March 31, 2001 as compared to $4.5 million for the three months ended March 31, 2000. The increase in general and administrative expenses is due

primarily to increases in the number of general and administrative staff to accommodate the growth in operations. We anticipate general and administrative expenses will increase in absolute dollars in future periods due to increases in staffing and infrastructure to support our e-Learning infrastructure and acquisitions. 7

AMORTIZATION OF ACQUIRED INTANGIBLES

Amortization of acquired intangibles for the three months ended March 31, 2001 was $2.3 million as compared to $1.7 million for the three months ended March 31, 2000. Amortization of acquired intangibles increased due to the additional amortization of acquired intangibles in the three months ended March 31, 2001, as compared to the three months ended March 31, 2000 as a result of the acquisitions of AES and Learning Productions in March and April 2000, respectively. We expect that amortization of acquired intangibles will increase in future periods as a result of the acquisition of icGlobal.

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OTHER INCOME, NET

Other income, net, comprises interest income, interest expense, foreign currency exchange gains and losses and gains and losses due to hedge ineffectiveness.

We recognized other income, net, of $0.8 million for the three months ended March 31, 2001, as compared to other income, net, of $1.1 million for the three months ended March 31, 2000. Other income decreased primarily due to lower interest income resulting from lower prevailing interest rates and foreign exchange losses. Included in other income, net, was net exchange losses of $0.4 million for the three months ended March 31, 2001, compared to net exchange losses of $0.2 million for the three months ended March 31, 2000. The net exchange losses incurred were primarily as a result of adopting Statement 133 on January 1, 2001 and the strengthening of the U.S. dollar against the Euro and other currencies.

Our consolidated financial statements are prepared in dollars, although several of our subsidiaries have functional currencies other than the dollar, and a significant portion of our revenues, costs and assets and those of our

subsidiaries are denominated in currencies other than their respective functional currencies. We have significant subsidiaries in the United Kingdom, Australia, the Netherlands and Canada whose functional currencies are their local currencies and the majority of whose sales and operating expenses other than cost of goods sold are denominated in their respective local currencies. In addition, our Irish subsidiaries, whose functional currency is the U.S. dollar, incur substantial operating expenses denominated in Irish pounds. Fluctuations in exchange rates may have a material adverse effect on our results of operations, particularly our operating margins, and could result in exchange losses, as it has done in the three months ended March 31, 2001. The impact of future exchange rate fluctuations on our results of operations cannot be accurately predicted.

As of March 31, 2001 we have entered into forward currency exchange contracts to hedge identified expenses denominated in Irish pounds. We have not sought to hedge the risks associated with fluctuations in the exchange rates of other currencies against the U.S Dollar, but may undertake such transactions in the future. Any hedging techniques implemented by us may not be successful in eliminating or reducing the effects of currency fluctuations. Fluctuations in exchange rates may have a material adverse effect on our results of operations, particularly our operating margins, and could result in exchange losses. The impact of future exchange rate fluctuations on the results of operations cannot be accurately predicted. [8]

Other income, net may fluctuate in future periods as a result of movements in cash, cash equivalents and short-term investment balances, interest rates, foreign currency exchange rates, ineffectiveness of foreign currency exchange contracts, asset and investment disposals and write downs.

PROVISION FOR INCOME TAXES

We operate as a holding company with operating subsidiaries in several countries, and each subsidiary is taxed based on the laws of the jurisdiction in which it operates. Because taxes are incurred at the subsidiary level, and one subsidiary's tax losses cannot be used to offset the taxable income of subsidiaries in other tax jurisdictions, our consolidated effective tax rate may increase to the extent that we report tax losses in some subsidiaries and taxable income in others.

We have significant operations and generate a majority of our taxable income in the Republic of Ireland, and certain of our Irish operating subsidiaries are taxed at rates substantially lower than tax rates in effect in the United States and other countries in which we have operations. Two Irish subsidiaries currently qualify for a 10% tax rate and another Irish subsidiary is income tax exempt. If such subsidiaries were no longer to qualify for such tax rates or if the tax laws were rescinded or changed, our operating results could be materially adversely affected. Moreover, because we incur income

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8 This paragraph consists of forward-looking statements reflecting our current expectations. Our actual future performance may differ materially from our current expectations. You are strongly encouraged to review the section entitled "Additional Risk Factors That Could Affect Operating Results" commencing on page 15 and discussions elsewhere in this Quarterly Report on Form 10-Q of the factors that could affect future performance.

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tax in several countries, an increase in our profitability in one or more of these countries could result in a higher overall tax rate. In addition, if tax

authorities were to challenge successfully the manner in which profits are recognized among our subsidiaries, our taxes could increase and our cash flow and net income could be materially adversely affected.

We recorded a tax provision of $0.3 million, at an effective tax rate of 12% before amortization of acquired intangibles, in the three months ended March 31, 2001. We recorded a tax benefit of $1.1 million, at an effective tax rate of 10% before amortization of acquired intangibles, in the three months ended March 31, 2000 as a result of the loss for 2000, which was recognized for tax purposes by one of our Irish subsidiaries.

LIQUIDITY AND CAPITAL RESOURCES

Cash and short-term investments at March 31, 2001 were $91 million compared to $108 million at December 31, 2000. Working capital was $115.4 million as of March 31, 2001 compared to $112.4 million as of December 31, 2000. The decrease in cash and short term investments is due principally to cash outflows from operations and investments in property and equipment to support the building of our e-Learning infrastructure and expanded operations.

CASH FLOWS FROM OPERATING ACTIVITIES. Net cash used by operating activities was $18.1 million for the three months ended March 31, 2001 compared to net cash used by operating activities of $2.7 million for the three months ended March 31, 2000. During the three months ended March 31, 2001, cash outflows from operations increased from that for the three months ended March 31, 2000, primarily as a result of the increase in accounts receivable and prepaid expenses and other assets from December 31, 2000 to March 31, 2001 as compared to the movement in accounts receivable and prepaid expenses and other assets from December 31, 1999 to March 31, 2000. The increase in the accounts receivable balance is a function of the revenue for the current and earlier periods and the timing of payments in respect of receivables.

CASH FLOWS FROM INVESTING ACTIVITIES. Net cash used by investing activities was $5.8 million for the three months ended March 31, 2001 compared to net cash used by investing activities of $5.2 million for the three months ended March 31, 2000. The increase in cash outflow from investing activities was primarily due to increased capital expenditure required to continue to build our e-Learning infrastructure and to support our expanding operations. We expect to continue to make significant investments to our e-Learning infrastructure and information systems to support our e-Learning solutions and the growth in operations. 9

CASH FLOWS FROM FINANCING ACTIVITIES. Net cash provided by financing activities increased to $6.8 million for the three months ended March 31, 2001 from $3.7 million for the three months ended March 31, 2000. The increase is attributable to increased employee stock option exercises during the three months ended March 31, 2001 as compared with the three months ended March 31, 2000.

We believe our existing cash, cash equivalents and short-term investments and cash to be generated from operations will be sufficient to meet our expected working capital and capital expenditure requirements for at least the next twelve months. 10 We may from time to time consider the acquisition of complementary businesses, products or technologies, which may require additional financing or pursue other strategic capital raising.

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9 This paragraph consists of forward-looking statements reflecting our current expectations. Our actual future performance may differ materially from our current expectations. You are strongly encouraged to review the section entitled "Additional Risk Factors That Could Affect Operating Results" commencing on page 15 and discussions elsewhere in this Quarterly Report on Form

10-Q of the factors that could affect future performance.

10 This statement is a forward-looking statement and actual results may differ materially depending on a variety of factors, including variable operating results or presently unexpected uses of cash such as mergers and acquisitions.

ADDITIONAL RISK FACTORS THAT COULD AFFECT OPERATING RESULTS

IMPORTANT NOTE ABOUT FORWARD LOOKING STATEMENTS

In addition to historical statements, this Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Words such as "anticipates", "expects", "intends", "plans", "believes", "seeks", "estimates" and similar expressions identify such forward looking statements. These forward looking statements are not guarantees of future performance and are subject to certain risks and uncertainties that could cause actual results to differ materially from those expressed or forecasted. Actual results may vary because of factors such as product ship schedules, life cycles, terms and conditions, product mix, competitive products and pricing, customer demand, technological shifts, litigation and other issues discussed elsewhere in this Quarterly Report and in our most recent Annual Report, as amended on Form 10-K/A for the fiscal year ended December 31, 2000. These forward-looking statements reflect management's opinions only as of the date hereof, and we assume no obligation unless required by law to revise or publicly release the results of any revision to these forward-looking statements. Risks and uncertainties include, but are not limited to, those discussed in the section entitled "Additional Risk Factors That Could Affect Operating Results." Other risks and uncertainties are disclosed in our SEC filings, including our Annual Report, as amended on Form 10-K/A, for the year ended December 31, 2000. Historical results are not necessarily indicative of trends in operating results for any future period.

In addition to the other factors identified in this Quarterly Report on Form 10-Q, the following risk factors could materially and adversely affect our future operating results and could cause actual events to differ materially from those predicted in our forward looking statements relating to our business. These risk factors should be carefully considered in evaluating SmartForce and its business because such factors currently have a significant impact on SmartForce's business, operating results and financial condition.

OUR QUARTERLY OPERATING RESULTS MAY FLUCTUATE SIGNIFICANTLY. THIS LIMITS YOUR ABILITY TO EVALUATE OUR HISTORICAL FINANCIAL RESULTS AND INCREASES THE LIKELIHOOD THAT OUR RESULTS WILL FALL BELOW MARKET ANALYSTS' EXPECTATIONS, WHICH COULD CAUSE THE PRICE OF OUR ADSS TO DROP RAPIDLY AND SEVERELY.

We have in the past experienced fluctuations in our quarterly operating results and anticipate that these fluctuations will continue and could intensify in the future. As a result, we believe that our quarterly revenue, expenses and operating results are likely to vary significantly in the future. Thus, it is likely that in some future quarters our results of operations will be below the expectations of public market analysts and investors, which could have a severe adverse effect on the price of our ADSs. For example, our revenue for the quarter ended September 30, 1998 did not increase at a rate comparable to prior quarters. As a direct result, the trading price of our ADSs decreased rapidly and significantly, having an extreme adverse effect on the value of an investment in our securities.

Our operating results have historically fluctuated, and may in the future continue to fluctuate, as a result of factors, which include:

- the size and timing of new and renewal agreements
- the rate at which we continue to migrate our customers to our e-Learning solutions
- the number and size of outsourced virtual university agreements or other agreements providing for professional services or the resale of instructor-led training
- the mix of revenue between content, e-Learning platform, services and partner's products
- royalty rates
- the announcement, introduction and acceptance of new products, product enhancements and technologies by us and our competitors
- the mix of sales between our field sales force, our other direct sales channels and our telesales sales channels
- the impact of any unanticipated decline in net revenues in any particular quarter as compared to the relatively fixed nature of our expense levels in the short term
- general conditions in our market or the markets served by our customers in the U.S. and or the International economy
- competitive conditions in the industry

- the loss of significant customers
- delays in availability of existing or new products
- the spending patterns of our customers
- litigation costs and expenses
- currency fluctuations
- the length of sales cycles

WE HAVE RECENTLY INTRODUCED FULLY INTEGRATED, INTERNET-BASED LEARNING SOLUTIONS, AN AREA IN WHICH WE HAVE LIMITED EXPERIENCE.

In the fourth quarter of 1999 we introduced SmartForce e-Learning, a hosted Internet-based learning solution. While the results of our efforts to migrate our business to the e-Learning model during 2000 exceeded our expectations, we have relatively limited experience with these solutions, which makes our historical results of limited value in predicting the potential success of this initiative. The ultimate success of this initiative will depend on our ability to build-out and maintain our e-Learning infrastructure, to market and sell the new e-Learning solutions to existing and prospective customers, to create a significant subscriber base for our e-Learning destination Web site, to host, operate and manage our destination site, and to attract and retain key management and technical personnel.

We may not be successful in these efforts and the economic terms of any arrangements that might be expected may not be as favorable as the traditional licensing agreements. We believe that a lack of success in this regard could have a material negative effect on us. Moreover, to the extent that we are successful in our efforts to enter into e-Learning agreements with our customers, those arrangements are expected to have accounting and operating model consequences that would also be materially different from the consequences of our traditional software licensing model.

OUR OPERATING RESULTS ARE SUBJECT TO SEASONAL FLUCTUATIONS WHICH MAY ADVERSELY IMPACT OUR BUSINESS.

Our operating results are subject to seasonal fluctuations, based in part

on customers' annual budgetary cycles and in part on the annual nature of sales quotas. These seasonal trends have in the past caused revenues in the first quarter of a year to be less, perhaps substantially so, than revenues for the immediately preceding fourth quarter. We expect that these seasonal trends could continue to adversely affect our revenues. In addition, we have in past years added significant headcount in the sales and marketing and research and development functions in the first quarter, and to a lesser extent, the second quarter. Because these headcount additions do not immediately contribute significant revenues, our operating margins in the earlier part of the year tend to be significantly lower than in the later parts of the year. In addition, many technology companies also experience a seasonal downturn in demand during the summer months. These seasonal trends may have a material adverse effect on our results of operations.

WE RELY ON STRATEGIC ALLIANCES THAT MAY NOT CONTINUE IN THE FUTURE.

We have developed strategic alliances to develop and market many of our products, and we believe that an increasing proportion of our future revenues may be attributable to products developed and marketed through these and other future alliances. However, these relationships are not exclusive and we may be unable to continue to develop future products through these alliances in a timely fashion or may be unable to negotiate additional alliances in the future on acceptable terms or at all.

The marketing efforts of our partners may also disrupt our direct sales efforts. Our development and marketing partners could pursue their existing or alternative training programs in preference to and in competition with those being developed by us. In the event that we are unable to maintain or expand our current development and marketing alliances or enter into new development and marketing alliances, our operating results and financial condition could be materially adversely affected. Furthermore, we are required to pay royalties to our development and marketing partners on products developed with them, which reduces our gross margins. We expect that cost of revenues may fluctuate from period to period in the future based upon many factors, including the revenue mix (between content, e-Learning platform, services and partner's products) and the timing of expenses associated with development and marketing alliances. In addition, the

collaborative nature of the development process under these alliances may result in longer development times and less control over the timing of product introductions than for e-Learning offerings developed solely by us. Our strategic alliance partners may from time to time renegotiate the terms of our agreement with them and could result in changes to the royalty arrangements, which could adversely effect our results of operations.

OUR SUCCESS DEPENDS ON OUR ABILITY TO MEET THE NEEDS OF THE RAPIDLY CHANGING MARKET.

The market for interactive education and training is influenced by rapidly changing technology, evolving industry standards, changes in customer requirements and preferences and frequent introductions of new products and services embodying new technologies. New methods of providing interactive education in a technology-based format are being developed and offered in the marketplace, including intranet and Internet offerings. Many of these new offerings involve new and different business models and contracting mechanisms. In addition, multimedia and other product functionality features are being added to the educational software. Accordingly, our future success will depend upon the extent to which we are able to develop and implement products which address these emerging market requirements on a cost effective and timely basis. Product

development is risky because it is difficult to foresee developments in technology, coordinate technical personnel and identify and eliminate design flaws. Any significant delay in releasing new products could have a material adverse effect on the ultimate success of our products and could reduce sales of predecessor products. We may not be able to introduce new products on a timely basis. In addition, new products introduced by us may fail to achieve a significant degree of market acceptance or, once accepted, may fail to sustain viability in the market for any significant period. If we are unsuccessful in addressing the changing needs of the marketplace due to resource, technological or other constraints, or in anticipating and responding adequately to changes in customers' software technology and preferences, our business and results of operations would be materially adversely affected.

THE SUCCESS OF OUR E-LEARNING STRATEGY DEPENDS ON THE RELIABILITY AND CONSISTENT PERFORMANCE OF OUR INFORMATION SYSTEMS AND INTERNET INFRASTRUCTURE.

The success of our e-Learning strategy is highly dependent on the consistent performance of our information systems and Internet infrastructure. If our Web site fails for any reason or if we exercise any unscheduled down times, even for only a short period of time, our business and reputation could be materially harmed. We have in the past experienced performance problems and unscheduled downtime, and these problems could recur. We rely on third parties for proper functioning of our computer infrastructure, delivery of our e-Learning application and the performance of our destination site. Our systems and operations could be damaged or interrupted by fire, flood, power loss, telecommunications failure, break-ins, earthquake and similar events. Any system failures could adversely affect customer usage of our solutions and user traffic results in any future quarters, which could adversely affect our revenues and operating results and harm our reputation with corporate customers, subscribers and commerce partners. A key element of our strategy is to generate a high volume of traffic to the Web site and create a significant subscriber base. Accordingly, the satisfactory performance, reliability and availability of our Web site and computer infrastructure is critical to our reputation and ability to attract and retain corporate customers, subscribers and commerce partners. We cannot accurately project the rate or timing of any increases in traffic to our Web site and, therefore, the integration and timing of any upgrades or enhancements required to facilitate any significant traffic increase to the Web site are uncertain. We have in the past experienced difficulties in upgrading our site infrastructure to handle increased traffic, and these difficulties could recur. The failure to expand and upgrade the Web site or any system error, failure or extended down time could materially harm our business, reputation, financial condition or results of operations.

Our facilities in the State of California, including our corporate headquarters and other critical business operations, are currently subject to electrical blackouts as a consequence of a shortage of available power. In the event these blackouts continue to increase in severity, they could disrupt the operations of our affected facilities and our business could be seriously harmed. In addition, in connection with the shortage of available power, prices for electricity have risen dramatically, and will likely to continue to increase in the foreseeable future. Such price changes will increase our operating costs, which could adversely impact our profitability.

THE INTERNET-BASED LEARNING MARKET IS A DEVELOPING MARKET, AND OUR BUSINESS WILL SUFFER IF E-LEARNING IS NOT WIDELY ACCEPTED.

The market for Internet-based enterprise learning is a new and emerging market. Corporate training and education has historically been conducted

primarily through classroom instruction and has traditionally been performed by a company's internal personnel. Many companies have invested heavily in their current training solutions. Although technology-based training applications have been available for several years, they currently account for only a small portion of the overall training market.

Accordingly, our future success will depend upon the extent to which companies adopt technology-based solutions and use the Internet in connection with their training activities, and the extent to which companies utilize the services or purchase products of third-party providers. Many companies that have already invested substantial resources in traditional methods of corporate training may be reluctant to adopt a new strategy that may compete with their existing investments. Even if companies implement technology-based training or Internet learning solutions, they may still choose to design, develop, deliver or manage all or part of their education and training internally. If technology based learning and the use of the Internet for learning does not become widespread, or if companies do not use the products and services of third parties to develop, deliver or manage their training needs, then our products and services, may not achieve commercial success.

WE MAY FAIL TO INTEGRATE ADEQUATELY ACQUIRED PRODUCTS, TECHNOLOGIES AND BUSINESSES.

As a result of the consummation of a number of acquisitions our operating expenses have increased. The integration of these businesses may not be successfully completed in a timely fashion, or at all. Further, the revenues from the acquired businesses may not be sufficient to support the costs associated with those businesses, without adversely affecting our operating margins. Any failure to successfully complete the integration in a timely fashion or to generate sufficient revenues from the acquired businesses could have a material adverse effect on our business and results of operations.

In April 2001 we acquired icGlobal, providers of industry acclaimed Learning Management System software. Difficulties in combining the company's products and technologies with our own could have an adverse impact on our ability to fully benefit from our existing and future investment in this business and on the future prospects for our business, management and professional education software products.

We regularly evaluate acquisition opportunities and are likely to make acquisitions in the future that would provide additional product or service offerings, additional industry expertise or an expanded geographic presence. We may be unable to locate attractive opportunities or acquire any that we locate on attractive terms. Future acquisitions could result in potentially dilutive issuances of equity securities, the incurrence of debt and contingent liabilities and amortization expenses related to goodwill and other intangible assets, which could materially adversely affect our results of operations. Product and technology acquisitions entail numerous risks, including difficulties in the assimilation of acquired operations, technologies and products, diversion of management's attention to other business concerns, risks of entering markets in which we have no or limited prior experience and the potential loss of key employees of acquired companies. We may be unable to integrate successfully any operations, personnel or products that have been acquired or that might be acquired in the future and our failure to do so could have a material adverse effect on our results of operations.

RAPID EXPANSION OF OUR OPERATIONS COULD STRAIN OUR PERSONNEL AND SYSTEMS.

We have recently experienced rapid expansion of our operations, which has placed, and is expected to continue to place, significant demands on our executive, administrative, operational and financial personnel and systems. Our future operating results will substantially depend on the ability of our officers and key employees to manage changing business conditions and to implement and improve our operational, financial control and reporting systems. In particular, we require significant improvement in our order entry, fulfillment and management information systems in order to support our expanded operations. If we are unable to respond to and manage changing business conditions, our business and results of operations could be materially adversely affected.

OUR EXPENSE LEVELS ARE FIXED IN THE SHORT TERM AND WE MAY BE UNABLE TO ADJUST SPENDING TO COMPENSATE FOR UNEXPECTED REVENUE SHORTFALLS.

Our expense levels are based in significant part on our expectations regarding future revenues and are fixed to a large extent in the short term. Accordingly, we may be unable to adjust spending in a timely manner to compensate for any unexpected revenue shortfall. Any significant revenue shortfall would therefore have a material adverse effect on our results of operations. This risk materialized in the third quarter of 1998, where profit was dramatically negatively affected by a shortfall in revenues as against management's expectations.

WE DEPEND ON A FEW KEY PERSONNEL TO MANAGE AND OPERATE US.

Our success is largely dependent on the personal efforts and abilities of our senior management. Failure to retain these executives, or the loss of certain additional senior management personnel or other key employees, could have a material adverse effect on our business and future prospects.

We are also dependent on the continued service of our key sales, content development and operational personnel and on our ability to attract, motivate and retain highly qualified employees. In addition, we depend on writers, programmers, Web designers and graphic artists. We expect to continue to hire additional content development, programmers, sales and marketing, information systems and accounting staff. However, we may be unsuccessful in attracting, retaining or motivating key personnel. The inability to hire and retain qualified personnel or the loss of the services of key personnel could have a material adverse effect upon our current business, new product development efforts and future business prospects.

INCREASED COMPETITION MAY RESULT IN DECREASED DEMAND FOR OUR PRODUCTS AND SERVICES, WHICH MAY RESULT IN REDUCED REVENUES AND GROSS MARGINS AND LOSS OF MARKET SHARE.

The market for business education training solutions is highly fragmented and competitive, and we expect this competition to increase. We expect that because of the lack of significant barriers to entry into this market, new competitors may enter the market in the future. In addition to increased competition from new companies entering into the market, established companies are entering into the market through acquisitions of smaller companies, which directly compete with us, and we expect this trend to continue. We expect the market to become increasingly competitive due to the lack of significant barriers to entry. We may also face competition from publishing companies and vendors of application software, including those vendors with whom we have formed development and marketing alliances.

Our primary source of direct competition comes from third-party suppliers of instructor-led information technology, business, management and professional skills education and training as well as suppliers of computer-based training and e-Learning solutions. We also face indirect competition from internal

education and training departments of our potential customers. We also compete to a lesser extent with consultants, value-added resellers and network integrators. Certain of these value-added resellers also market products competitive with ours. We expect that as organizations increase their dependence on outside suppliers of training, we will face increasing competition from these other suppliers as education and training managers more frequently compare training products provided by outside suppliers.

Growing competition may result in reduced revenue and gross margins and loss of market share, any one of which have a material adverse effect on our business. Many of our current and potential competitors have substantially greater financial, technical, sales, marketing and other resources, as well as greater name price competition, and we expect that we will face increasing price pressures from competitors as managers demand more value for their training budgets.

Accordingly, we may be unable to provide e-Learning solutions that compare favorably with new instructor-led techniques, other interactive training software or new e-Learning solutions or competitive pressures may require us to reduce our prices significantly.

OUR BUSINESS IS SUBJECT TO CURRENCY FLUCTUATIONS THAT CAN ADVERSELY AFFECT OUR OPERATING RESULTS.

Due to our multinational operations, our business is subject to fluctuations based upon changes in the exchange rates between the currencies in which we collect revenues or pay expenses. In particular, the value of the U.S. dollar against the Euro and related currencies impacts our operating results. Our expenses are not necessarily incurred in the currency in which revenue is generated, and, as a result, we are required from time to time to convert currencies to meet our obligations. These currency conversions are subject to exchange rate fluctuations, and changes to the value of the Euro, pound sterling and other currencies relative to the U.S. dollar could adversely affect our business and results of operations.

OUR CORPORATE TAX RATE MAY INCREASE, WHICH COULD ADVERSELY IMPACT OUR CASH FLOW, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

We have significant operations and generate a majority of our taxable income in the Republic of Ireland, and some of our Irish operating subsidiaries are taxed at rates substantially lower than tax rates in effect in the United States and other countries in which we have operations. If our Irish subsidiaries were no longer to qualify for these lower tax rates or if the applicable tax laws were rescinded or changed, our operating results could be materially adversely affected. Moreover, because we incur income tax in several countries, an increase in our profitability in one or more of these countries could result in a higher overall tax rate. In addition, if U.S. or other foreign tax authorities were to change applicable tax laws or successfully challenge the manner in which our subsidiaries' profits are currently recognized, our taxes could increase, and our business, cash flow, financial condition and results of operations could be materially adversely affected.

WE MAY BE UNABLE TO PROTECT OUR PROPRIETARY RIGHTS. UNAUTHORIZED USE OF OUR TECHNOLOGY MAY RESULT IN DEVELOPMENT OF PRODUCTS OR SERVICES THAT COMPETE WITH OURS.

Our success depends on our ability to protect our rights in our intellectual property and trade secrets. We rely upon a combination of

copyright, trademark and trade secret laws and customer license agreements, and other methods to protect our proprietary rights. We also enter into confidentiality agreements without employees, consultants and third parties to seek to limit and protect the distribution of our proprietary information regarding this technology. However, we have not signed protective agreements in every case. Unauthorized parties may copy aspects of our products, services or technology or obtain and use information that we regard as proprietary. Other parties may breach confidentiality agreements and other protective contracts we have executed. We may not become aware of, or have adequate remedies in the event of, a breach. Litigation may be necessary in the future to enforce our intellectual property rights, to protect trade secrets or to determine the validity and scope of the proprietary rights of others. This litigation could result in substantial costs and diversion of management and technical resources.

SOME MAY CLAIM THAT WE INFRINGE THEIR INTELLECTUAL PROPERTY RIGHTS, WHICH COULD RESULT IN COSTLY LITIGATION OR REQUIRE US TO REENGINEER OR CEASE SALES OF OUR PRODUCTS OR SERVICES.

Third parties could in the future claim that our current or future products infringe their intellectual property rights. Any claim, with or without merit, could result in costly litigation or require us to reengineer or cease sales of our products or services, any of which could have a material adverse effect on our business. Infringement claims could also result in an injunction in the use of our products or require us to enter into royalty or licensing agreements. Licensing agreements, if required, may not be available on terms acceptable to us or at all. Though no legal actions are pending at this time, from time to time we learn of parties that claim broad intellectual property rights in the e-Learning area that might implicate our offerings. These parties or others could initiate actions against us in the future.

WE ARE SUBJECT TO A PENDING LEGAL PROCEEDING AND MAY BECOME SUBJECT TO ADDITIONAL PROCEEDINGS AND ADVERSE DETERMINATIONS IN THESE PROCEEDINGS COULD HARM OUR BUSINESS.

Since the end of the third quarter of 1998, a class action lawsuit has been pending in the United States District Court for the Northern District of California against us, one of our subsidiaries, SmartForce USA and certain of our former and current officers and directors alleging violation of the federal securities laws. It has been alleged in this lawsuit that we misrepresented or omitted to state material facts regarding our business and financial condition and prospects in order to artificially inflate and maintain the price of our ADSs, and misrepresented or omitted to state material facts in our registration statement and prospectus issued in connection with our merger with ForeFront, which also is alleged to have artificially inflated the price of our ADSs.

We believe that this action is without merit and intend to vigorously defend ourselves against it. Although we cannot presently determine the outcome of this action, an adverse resolution of this matter could significantly negatively impact our financial position and results of operations.

We may be from time to time involved in various lawsuits and legal proceedings, which arise in the ordinary course of business. An adverse resolution of these matters could significantly negatively impact our financial position and results of operations.

OUR NON-U.S. OPERATIONS ARE SUBJECT TO RISKS WHICH COULD NEGATIVELY IMPACT OUR FUTURE OPERATING RESULTS.

We expect that international operations will continue to account for a

significant portion of our revenues, and intend to continue to expand our operations outside of the United States. Operations outside of the United States are subject to inherent risks, including difficulties or delays in developing and supporting non-English language versions of our products and services, political and economic conditions in various jurisdictions, in staffing and managing foreign subsidiary operations, longer account receivable payment cycles and potential adverse tax consequences. Any of these factors could have a material adverse effect on our future operations outside of the United States, which could negatively impact our future operating results.

BECAUSE MANY USERS OF OUR E-LEARNING SOLUTIONS ACCESS THEM OVER THE INTERNET, FACTORS ADVERSELY AFFECTING THE USE OF THE INTERNET COULD HARM OUR BUSINESS.

Many of our users access our e-Learning solutions over the Internet. Any factors that adversely affect Internet usage could disrupt the ability of those users to access our e-Learning solutions, which would adversely effect customer satisfaction and therefore our business. Factors which could disrupt Internet usage include slow access to download times, security concerns, network problems or service disruptions that prevent users from accessing an Internet server and delays in, or disputes concerning, the development of industry wide Internet standards and protocols.

DEMAND FOR OUR PRODUCTS AND SERVICES MAY BE ESPECIALLY SUSCEPTIBLE TO ADVERSE ECONOMIC CONDITIONS.

Our business and financial performance may be damaged by adverse financial conditions affecting our target customers or by a general weakening of the economy. Some companies may not view training products and services as critical to the success of their businesses. If these companies experience disappointing operating results, whether as a result of adverse economic conditions, competitive issues or other factors, they may decrease or forego education and training expenditures before limiting their other expenditures.

THE MARKET PRICE FOR OUR ADSS MAY FLUCTUATE AND MAY NOT BE SUSTAINABLE.

Our initial public offering of our ADSs was completed in April 1995. There can be no assurance that a viable public market for our ADSs will be sustained. The market price of our ADSs has fluctuated significantly since our initial public offering and is likely to continue to be volatile. We believe that factors, such as the following, could cause the price of our ADSs to fluctuate, perhaps substantially:

- announcements of developments related to ourselves or our competitors' business
- announcements of new products or enhancements by ourselves or our competitors
- sales of our ADSs into the public market
- developments in our relationships with our customers, partners and distributors
- shortfalls or changes in revenues, gross margins, earnings or losses or other financial results which differ from public market expectations
- changes in the public market expectation of our performance or industry performance
- changes in market valuations of competitors
- regulatory developments
- additions or departures of key personnel
- fluctuations in results of operations and
- general conditions in our market or the markets served by our customers or in the U.S. and or the International economy.

In addition, in recent years the stock market in general, and the market for shares of technology stocks in particular, has experienced extreme price and volume fluctuations, which have often been unrelated to the operating performance of affected companies. The market price of our ADSs may continue to experience significant fluctuations in the future, including fluctuations that are unrelated to our performance.

To succeed we must continue to expand our content offerings, upgrade our technology and distinguish our solution. We may not be able to do successfully. Any failure by us to anticipate or respond adequately to changes in technology and customer preferences or any significant delays in content development or implementation could impact our ability to capture market share.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

Our exposure to market risk for changes in interest rates relate primarily to our cash and short term investment portfolio. We do not use any derivative financial instruments in our cash and short term investment portfolio. The primary objective of our investment activities is to preserve capital while maximizing yields without significantly increasing risk. We achieve this by investing our excess cash in deposits with major banks and in U.S. Treasury and U.S. agency obligations and in debt securities of corporations with strong credit ratings. Due to the nature of our investments, we believe that there is no material risk exposure. All investments are carried at market value, which approximates cost.

The table below presents the principal amount and related weighed average interest rates for our cash and short term investment portfolio. Our short term investments are all in fixed rate instruments. The principal amounts approximate fair value at March 31, 2001.

TABLE OF CASH AND SHORT TERM INVESTMENTS:

	PRINCIPAL AMOUNT	AVERAGE INTEREST RATE
MARCH 31, 2001		
(Dollars in thousands)		
Cash and cash equivalents	$48,442	5%
Short term investments	42,984	5%
Total cash and investment securities	$91,426	

FOREIGN CURRENCY RISK

Due to our multinational operations, our business is subject to fluctuations based upon changes in the exchange rates between the currencies in which we collect revenues or pay expenses and the U.S. dollar Our expenses are not necessarily incurred in the currency in which revenue is generated, and, as a result, we are required from time to time to convert currencies to meet our obligations. These currency conversions are subject to exchange rate fluctuations, in particular changes to the value of the Euro and pound sterling

relative to the U.S. dollar, which could adversely affect our business and the results of operations.

At March 31, 2001, we had forward exchange contracts of $52 million outstanding. All contracts at March 31, 2001 expire at various times throughout 2001 and 2002. Our hedging policy is designed to reduce the impact of foreign currency exchange movements between the Irish pound and U. S. Dollar by hedging identifiable Irish pound denominated commitments. Our accounting policies for these instruments are based on our designation of such instruments as cash flow hedges. We do not use forward currency exchange contracts for speculative trading purposes.

Our outstanding foreign currency forward exchange contracts at March 31, 2001, are presented in the table below. The weighted average exchange rate quoted represents the financial currency to the U.S. dollar.

Functional Currency	Amount	Expected Maturity Quarter Ended	Weighted Average Exchange Rate
Irish pounds	$ 7,000,000	June 30, 2001	1.1695
Irish pounds	$ 7,000,000	September 30, 2001	1.2112
Irish pounds	$ 8,000,000	December 31, 2001	1.1707
Irish pounds	$10,000,000	March 31, 2002	1.0722
Irish pounds	$10,000,000	June 30, 2002	1.0939
Irish pounds	$ 5,000,000	September 30, 2002	1.1154
Irish pounds	$ 5,000,000	December 31, 2002	1.1187

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Since the end of the third quarter of 1998, a class action lawsuit has been filed in United States District Court for the Northern District of California against us, one of our subsidiaries, SmartForce USA and certain of our former and current officers and directors alleging violation of the federal securities laws. It has been alleged in this lawsuit that we misrepresented or omitted to state material facts regarding our business and financial condition and prospects in order to artificially inflate and maintain the price of our ADSs, and misrepresented or omitted to state material facts in our registration statement and prospectus issued in connection with our merger with ForeFront, which also is alleged to have artificially inflated the price of our ADSs.

We believe that this action is without merit and intend to vigorously defend ourselves against it. Although we cannot presently determine the outcome of this action, an adverse resolution of this matter could significantly negatively impact our financial position and results of operations.

ITEM 2. CHANGES IN SECURITIES

On April 2, 2001 we issued to the icGlobal shareholders the right to acquire an aggregate of 100,000 ADSs as consideration for our acquisition of the

outstanding securities of icGlobal. The issuance of the ADSs was, exempt from the registration requirements of the Securities Act of 1933, as amended, pursuant to Section 4(2) thereof, as the transaction did not involve a public offering.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

There are no exhibits attached to this Quarterly Report on Form 10-Q.

(b) Reports on Form 8-K

We did not file any report on Form 8-K with the Securities and Exchange Commission in the three months ended March 31, 2001.

SIGNATURE

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

SMARTFORCE PLC

Date: May 15, 2001 By: /s/ Gregory M. Priest

Gregory M. Priest
Chairman of the Board, President and
Chief Executive Officer

Date: May 15, 2001 By: /s/ David C. Drummond

David C. Drummond
Director, Executive Vice President
of Finance and
Chief Financial Officer

>

16,979

Selling, marketing and distribution

28,292

35,842

60,225

69,663

General and administrative

16,489

16,819

32,704

34,557

Operating Earnings

18,446

67,063

24,575

119,417

Interest expense

1,221

1,906

2,587

3,509

Other expense (income), net

91

98

686

(17)

Earnings Before Income Taxes

17,134

65,059

21,302

115,925

Income taxes

5,500

22,600

6,900

37,900

Net Earnings

$ 11,634

$ 42,459

$ 14,402

$ 78,025

Basic Net Earnings

per Common Share

$ 0.19

$ 0.70

$ 0.24

$ 1.28

Diluted Net Earnings

per Common Share

$ 0.19

$ 0.69

$ 0.24

$ 1.27

Cash Dividends Declared

per Common Share

$ 0.19

$ 0.19

$	0.38
$	0.37

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In thousands)

	June 26, 2009	December 26, 2008
ASSETS		
Current Assets		
Cash and cash equivalents	$ 13,909	$ 12,119
Accounts receivable, less allowances of $6,600 and $6,600	112,370	127,505
Inventories	68,536	91,604
Deferred income taxes	20,942	23,007
Other current assets	5,046	6,360
Total current assets	220,803	260,595
Property, Plant and Equipment		
Cost	333,778	326,729
Accumulated depreciation	(186,184)	(176,975)
Property, plant and equipment, net	147,594	149,754
Goodwill	91,740	91,740
Other Intangible Assets, net	46,406	52,231
Deferred Income Taxes	19,780	18,919
Other Assets	8,196	6,611
Total Assets	$ 534,519	$ 579,850
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Notes payable to banks	$ 14,664	$ 18,311
Trade accounts payable	15,452	18,834
Salaries, wages and commissions	11,148	17,179
Dividends payable	11,386	11,312
Other current liabilities	50,685	55,524
Total current liabilities	103,335	121,160
Long-term Debt	143,915	180,000
Retirement Benefits and Deferred Compensation	111,125	108,656
Uncertain Tax Positions	2,700	2,400
Shareholders' Equity		
Common stock	59,910	59,516
Additional paid-in-capital	184,642	174,161
Retained earnings	(30)	8,445
Accumulated other comprehensive income (loss)	(71,078)	(74,488)
Total shareholders' equity	173,444	167,634
Total Liabilities and Shareholders' Equity	$ 534,519	$ 579,850

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited) (In thousands)

	Twenty-six Weeks Ended	
	June 26, 2009	June 27, 2008
Cash Flows From Operating Activities		
Net Earnings	$ 14,402	$ 78,025
Adjustments to reconcile net earnings to net cash provided by operating activities		
Depreciation and amortization	16,953	15,737
Deferred income taxes	(696)	(4,243)
Share-based compensation	5,209	5,081
Excess tax benefit related to share-based payment arrangements	(300)	(2,923)
Change in		
Accounts receivable	15,370	(22,217)
Inventories	22,691	(13,060)
Trade accounts payable	(3,218)	3,580
Salaries, wages and commissions	(6,015)	(3,647)
Retirement benefits and deferred compensation	7,215	(1,018)
Other accrued liabilities	(2,135)	(607)
Other	16	315
Net cash provided by operating activities	69,492	55,023
Cash Flows From Investing Activities		
Property, plant and equipment additions	(9,129)	(12,944)
Proceeds from sale of property, plant and equipment	495	1,517
Investment in life insurance	(1,499)	(1,499)
Capitalized software and other intangible asset additions	(200)	(726)
Acquisitions of businesses, net of cash acquired	-	(35,266)
Net cash used in investing activities	(10,333)	(48,918)
Cash Flows From Financing Activities		
Net borrowings (payments) on short-term lines of credit	(3,621)	(660)
Borrowings on long-term line of credit	68,126	162,235
Payments on long-term line of credit	(104,211)	(80,395)
Excess tax benefit related to share-based payment arrangements	300	2,923
Common stock issued	5,289	13,176
Common stock retired	(141)	(80,130)
Cash dividends paid	(22,686)	(22,582)
Net cash provided by (used in) financing activities	(56,944)	(5,433)

Effect of exchange rate changes on cash	(425)	(705)
Net increase (decrease) in cash and cash equivalents	1,790	(33)
Cash and cash equivalents		
Beginning of year	12,119	4,922
End of period	$ 13,909	$ 4,889

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of June 26, 2009 and the related statements of earnings for the thirteen and twenty-six weeks ended June 26, 2009 and June 27, 2008, and cash flows for the twenty-six weeks ended June 26, 2009 and June 27, 2008 have been prepared by the Company and have not been audited.

In the opinion of management, these consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of Graco Inc. and Subsidiaries as of June 26, 2009, and the results of operations and cash flows for all periods presented.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. Therefore, these statements should be read in conjunction with the financial statements and notes thereto included in the Company’s 2008 Annual Report on Form 10-K.

The results of operations for interim periods are not necessarily indicative of results that will be realized for the full fiscal year.

2. The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2009	June 27, 2008	June 26, 2009	June 27, 2008
Net earnings available to common shareholders	$ 11,634	$ 42,459	$ 14,402	$ 78,025
Weighted average shares outstanding for basic earnings per share	59,903	60,540	59,770	60,897
Dilutive effect of stock options computed using the treasury stock method and the average market price	280	682	273	672
Weighted average shares outstanding for diluted earnings per share	60,183	61,222	60,043	61,569
Basic earnings per share	$ 0.19	$ 0.70	$ 0.24	$ 1.28
Diluted earnings per share	$ 0.19	$ 0.69	$ 0.24	$ 1.27

Stock options to purchase 3,920,000 and 1,889,000 shares were not included in the 2009 and 2008 computations

of diluted earnings per share, respectively, because they would have been anti-dilutive.

3. Information on option shares outstanding and option activity for the twenty-six weeks ended June 26, 2009 is shown below (in thousands, except per share amounts):

	Option Shares	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
Outstanding, December 26, 2008	3,955	$ 30.77	2,186	$ 24.98
Granted	1,180	20.74		
Exercised	(80)	7.82		
Canceled	(69)	33.62		
Outstanding, June 26, 2009	4,986	$ 28.73	2,525	$ 27.92

The aggregate intrinsic value of exercisable option shares was $6.5 million as of June 26, 2009, with a weighted

average contractual term of 4.5 years. There were approximately 4.9 million share options vested and expected to vest as of June 26, 2009, with an aggregate intrinsic value of $7.4 million, a weighted average exercise price of $28.73 and a weighted average contractual term of 6.7 years.

Information related to options exercised in the first six months of 2009 and 2008 follows (in thousands):

	Twenty-six Weeks Ended	
	June 26, 2009	June 27, 2008
Cash received	$ 622	$ 6,605
Aggregate intrinsic value	1,015	8,359
Tax benefit realized	400	3,000

The Company recognized year-to-date share-based compensation of $5.2 million in 2009 and $5.1 million in 2008. As of June 26, 2009, there was $9.7 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 2.4 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions and results:

	Twenty-six Weeks Ended	
	June 26, 2009	June 27, 2008
Expected life in years	6.0	6.0
Interest rate	2.1%	3.2%
Volatility	30.1%	25.0%
Dividend yield	3.7%	2.1%
Weighted average fair value per share	$ 4.27	$ 8.43

Under the Company’s Employee Stock Purchase Plan, the Company issued 312,000 shares in 2009 and 216,000 shares in 2008. The fair value of the employees’ purchase rights under this Plan was estimated on the date of grant. The benefit of the 15 percent discount from the lesser of the fair market value per common share on the first day and the last day of the plan year was added to the fair value of the employees’ purchase rights determined using the Black-Scholes option-pricing model with the following assumptions and results:

	Twenty-six Weeks Ended	
	June 26, 2009	June 27, 2008
Expected life in years	1.0	1.0
Interest rate	0.7%	1.5%
Volatility	51.5%	27.1%
Dividend yield	4.5%	2.1%
Weighted average fair value per share	$ 5.60	$ 8.14

4. The components of net periodic benefit cost (credit) for retirement benefit plans were as follows

(in thousands):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2009	June 27, 2008	June 26, 2009	June 27, 2008
Pension Benefits				
Service cost	$ 1,141	$ 1,412	$ 2,420	$ 2,803
Interest cost	3,115	3,144	6,335	6,290
Expected return on assets	(2,850)	(4,850)	(5,550)	(9,700)
Amortization and other	2,313	144	4,727	296
Net periodic benefit cost (credit)	$ 3,719	$ (150)	$ 7,932	$ (311)
Postretirement Medical				
Service cost	$ 100	$ 125	$ 250	$ 250
Interest cost	300	375	650	750
Amortization	-	-	-	-
Net periodic benefit cost	$ 400	$ 500	$ 900	$ 1,000

The Company paid $1.5 million in June 2009 and $1.5 million in June 2008 for contracts insuring the lives of certain employees who are eligible to participate in certain non-qualified pension and deferred compensation plans. These insurance contracts will be used to fund the non-qualified pension and deferred compensation arrangements. The insurance contracts are held in a trust and are available to general creditors in the event

of the Company's insolvency. Cash surrender value of $4.1 million and $2.7 million is included in other assets

in the consolidated balance sheet as of June 26, 2009 and December 28, 2008, respectively.

5. Total comprehensive income was as follows (in thousands):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2009	June 27, 2008	June 26, 2009	June 27, 2008
Net earnings	$ 11,634	$ 42,459	$ 14,402	$ 78,025
Cumulative translation adjustment	-	(26)	234	(31)
Pension and postretirement medical liability adjustment	2,422	65	4,751	189
Gain (loss) on interest rate hedge contracts	364	2,352	291	(423)
Income taxes	(1,030)	(893)	(1,866)	84
Comprehensive income	$ 13,390	$ 43,957	$ 17,812	$ 77,844

Components of accumulated other comprehensive income (loss) were (in thousands):

	June 26, 2009	December 26, 2008
Pension and postretirement medical liability adjustment	$ (67,329)	$ (70,322)
Gain (loss) on interest rate hedge contracts	(2,926)	(3,109)
Cumulative translation adjustment	(823)	(1,057)
Total	$ (71,078)	$ (74,488)

6. The Company has three reportable segments: Industrial, Contractor and Lubrication. The Company does not track assets by segment. Sales and operating earnings by segment for the thirteen and twenty-six weeks ended June 26, 2009 and June 27, 2008 were as follows (in thousands):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2009	June 27, 2008	June 26, 2009	June 27, 2008
Net Sales				
Industrial	$ 73,334	$ 133,092	$ 148,566	$ 247,343
Contractor	60,386	82,061	107,834	148,241
Lubrication	13,992	24,077	29,192	47,766
Consolidated	$ 147,712	$ 239,230	$ 285,592	$ 443,350
Operating Earnings				
Industrial	$ 13,435	$ 44,075	$ 24,930	$ 81,973

Contractor	12,043	20,741	13,282	34,437
Lubrication	(1,745)	4,607	(3,181)	8,924
Unallocated corporate (expense)	(5,287)	(2,360)	(10,456)	(5,917)
Consolidated	$ 18,446	$ 67,063	$ 24,575	$ 119,417

7. Major components of inventories were as follows (in thousands):

	June 26, 2009	December 26, 2008
Finished products and components	$ 42,981	$ 50,703
Products and components in various stages of completion	26,305	24,938
Raw materials and purchased components	33,917	51,348
	103,203	126,989
Reduction to LIFO cost	(34,667)	(35,385)
Total	$ 68,536	$ 91,604

8. Information related to other intangible assets follows (dollars in thousands):

	Estimated Life (years)	Original Cost	Accumulated Amortization	Foreign Currency Translation	Book Value
June 26, 2009					
Customer relationships	3 - 8	$ 41,075	$ (15,562)	$ (181)	$ 25,332
Patents, proprietary technology and product documentation	3 - 15	22,737	(12,026)	(87)	10,624
Trademarks, trade names and other	3 - 10	4,304	(1,384)	-	2,920
		68,116	(28,972)	(268)	38,876
Not Subject to Amortization:					
Brand names		7,530	-	-	7,530
Total		$ 75,646	$ (28,972)	$ (268)	$ 46,406
December 26, 2008					
Customer relationships	3 - 8	$ 41,075	$ (12,470)	$ (181)	$ 28,424
Patents, proprietary technology and product documentation	3 - 15	23,780	(11,290)	(87)	12,403
Trademarks, trade names and other	3 - 10	5,514	(3,908)	(12)	1,594
		70,369	(27,668)	(280)	42,421
Not Subject to Amortization:					
Brand names		9,810	-	-	9,810

Total	$	80,179	$	(27,668)	$	(280)	$	52,231

In the second quarter of 2009, the useful life of certain brand names was determined to be no longer indefinite. The original cost of such brand names, totaling $2.3 million, is being amortized over a three-year period beginning April 1, 2009. Amortization of intangibles was $3.0 million in the second quarter of 2009 and $5.8 million year-to-date. Estimated annual amortization expense is as follows: $11.2 million in 2009, $10.5 million in 2010, $9.4 million in 2011, $7.9 million in 2012, $4.1 million in 2013 and $1.6 million thereafter.

9. Components of other current liabilities were (in thousands):

	June 26, 2009		December 26, 2008	
Accrued self-insurance retentions	$	7,978	$	7,896
Accrued warranty and service liabilities	7,613		8,033	
Accrued trade promotions	4,235		9,001	
Payable for employee stock purchases	2,207		5,473	
Income taxes payable	4,555		904	
Other	24,097		24,217	
Total	$	50,685	$	55,524

A liability is established for estimated future warranty and service claims that relate to current and prior period sales. The Company estimates warranty costs based on historical claim experience and other factors including evaluating specific product warranty issues. Following is a summary of activity in accrued warranty and service liabilities (in thousands):

	Twenty-six Weeks Ended June 26, 2009		Year Ended December 26, 2008	
Balance, beginning of year	$	8,033	$	7,084
Charged to expense	2,416		6,793	
Margin on parts sales reversed	1,477		3,698	
Reductions for claims settled	(4,313)		(9,542)	
Balance, end of period	$	7,613	$	8,033

10. The Company accounts for all derivatives, including those embedded in other contracts, as either assets or liabilities and measures those financial instruments at fair value. The accounting for changes in the fair value of derivatives depends on their intended use and designation.

As part of its risk management program, the Company may periodically use forward exchange contracts and interest rate swaps to manage known market exposures. Terms of derivative instruments are structured to match the terms

of the risk being managed and are generally held to maturity. The Company does not hold or issue derivative financial

instruments for trading purposes. All other contracts that contain provisions meeting the definition of a derivative also

meet the requirements of, and have been designated as, normal purchases or sales. The Company’s policy is to not

enter into contracts with terms that cannot be designated as normal purchases or sales.

In 2007, the Company entered into interest rate swap contracts that effectively fix the rates paid on a total of $80 million of variable rate borrowings. One contract fixed the rate on $40 million of borrowings at 4.7 percent plus the applicable spread (depending on cash flow leverage ratio) until December 2010. The second contract fixed an additional $40 million of borrowings at 4.6 percent plus the applicable spread until January 2011. Both contracts have been designated as cash flow hedges against interest rate volatility. Consequently, changes in the fair market value are recorded in accumulated other comprehensive income (loss) (AOCI). Amounts included in AOCI will be reclassified to earnings as interest rates increase and as the swap contracts approach their expiration dates. Net amounts paid or payable under terms of the contracts were charged to interest expense and totaled $1.3 million in the first half of 2009.

The Company periodically evaluates its monetary asset and liability positions denominated in foreign currencies. The Company enters into forward contracts or options, or borrows in various currencies, in order to hedge its net monetary positions. These instruments are recorded at current market values and the gains and losses are included in other expense (income), net. There were seven contracts outstanding as of June 26, 2009, with notional amounts totaling $13 million. There were 33 contracts outstanding during all or part of the first half of 2009, with net losses of $0.4 million included in other expense (income), net. The Company believes it uses strong financial counterparts in these transactions and that the resulting credit risk under these hedging strategies is not significant.

The Company uses significant other observable inputs to value the derivative instruments used to hedge interest rate volatility and net monetary positions. The fair market value and balance sheet classification of such instruments follows (in thousands):

	Balance Sheet Classification	June 26, 2009	December 26, 2008
Gain (loss) on interest rate hedge contracts	Other current liabilities	$ (4,645)	$ (4,936)
Gain (loss) on foreign currency forward contracts			

Gains		$ 352	$ 1,868
Losses		(428)	(670)
Net	Accounts receivable		$ 1,198
	Other current liabilites	$ (76)	

11. In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, “Fair Value Measurements.” This statement establishes a consistent framework for measuring fair value and expands disclosures on fair market value measurements. SFAS No. 157 was effective for the Company starting in fiscal 2008 for financial assets and liabilities. With respect to non-financial assets and liabilities, the statement was effective for the Company starting in fiscal 2009. The adoption of this statement as it pertains to non-financial assets and liabilities had no significant impact on the consolidated financial statements.

12. The Company has evaluated subsequent events through the time the financial statements were approved for issuance on July 22, 2009.

Item 2. GRACO INC. AND SUBSIDIARIES

MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

The Company designs, manufactures and markets systems and equipment to move, measure, control, dispense and spray fluid materials. Management classifies the Company’s business into three reportable segments: Industrial, Contractor and Lubrication. Key strategies include development of new products, expansion of distribution and new market penetration.

The following Management’s Discussion and Analysis reviews significant factors affecting the Company’s results of operations and financial condition. This discussion should be read in conjunction with the financial statements and the accompanying notes to the financial statements.

Results of Operations

Net sales, net earnings and earnings per share were as follows (in millions except per share amounts and percentages):

	Thirteen Weeks Ended			Twenty-six Weeks Ended		
	June 26, 2009	June 27, 2008	% Change	June 26, 2009	June 27, 2008	% Change
Net Sales	$ 147.7	$ 239.2	(38)%	$ 285.6	$ 443.4	(36)%
Net Earnings	$ 11.6	$ 42.5	(73)%	$ 14.4	$ 78.0	(82)%
Diluted Net Earnings per Common Share	$ 0.19	$ 0.69	(72)%	$ 0.24	$ 1.27	(81)%

Weak economic conditions worldwide continued to affect the Company's operating results. Sales and orders decreased in all segments and regions. Currency translation had an unfavorable effect on sales ($5 million for the quarter and $11 million year-to-date) and net earnings ($2 million for the quarter and $4 million year-to-date). Year-to-date, the Company has recorded $5 million of cost related to workforce reductions, mostly in the first quarter. The resulting decrease in cost structure contributed to an improvement in second quarter net earnings compared to the first quarter.

Consolidated Results

Sales by geographic area were as follows (in millions):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2009	June 27, 2008	June 26, 2009	June 27, 2008
Americas [1]	$ 88.3	$ 131.9	$ 168.5	$ 247.8
Europe [2]	34.6	72.0	70.4	131.6
Asia Pacific	24.8	35.3	46.7	64.0
Consolidated	$ 147.7	$ 239.2	$ 285.6	$ 443.4

[1] North and South America, including the U.S.

[2] Europe, Africa and Middle East

Sales for the quarter are down 33 percent in the Americas, 52 percent in Europe (46 percent at consistent translation rates) and 29 percent in Asia Pacific. Year-to-date sales are down 32 percent in the Americas, 47 percent in Europe (40 percent at consistent translation rates) and 27 percent in Asia Pacific. Consolidated sales are down 38 percent for the quarter (36 percent at consistent translation rates) and 36 percent year-to-date (33 percent at consistent translation rates).

Gross profit margin, expressed as a percentage of sales, was 49.4 percent for the quarter and 48.1 percent year-to-date, down from 53.8 percent and 54.3 percent, respectively, for the comparable periods last year. Decreases in both the quarter and year-to-date are due to lower production volumes (approximately 4 percentage points), unfavorable currency translation rates (approximately 1½ percentage points) and increased pension cost (approximately 1 percentage point). Decreases were offset somewhat by favorable material costs (approximately 1 percentage point). Workforce reduction costs in the first quarter affected the year-to-date margin rate by approximately 1 percentage point.

Total operating expenses for the quarter and year-to-date are down 12 percent and 7 percent, respectively. Decreases from translation effects ($2 million for the quarter, $4 million year-to-date), lower incentive and bonus provisions and spending reductions are partially offset by higher product development and pension expenses. Increases in product development expense reflect the Company’s commitment to continued development of new and improved products as a key component of its strategy for future growth. Year-to-date operating expenses include approximately $2 million related to workforce reductions made primarily in the first quarter.

The effective income tax rate was 32.1 percent for the quarter compared to 34.7 percent for the second quarter of 2008. The rate was higher in 2008 because the R&D tax credit was not renewed until the fourth quarter and no credit was included in the second quarter provision.

Segment Results

Certain measurements of segment operations compared to last year are summarized below:

Industrial

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2009	June 27, 2008	June 26, 2009	June 27, 2008
Net sales (in millions)				
Americas	$ 35.5	$ 61.6	$ 71.3	$ 114.9
Europe	19.8	46.1	43.7	85.8
Asia Pacific	18.0	25.4	33.6	46.6
Total	$ 73.3	$ 133.1	$ 148.6	$ 247.3
Operating earnings as a percentage of net sales	18%	33%	17%	33%

For the quarter, Industrial segment sales decreased 42 percent in the Americas, 57 percent in Europe (52 percent at consistent translation rates) and 29 percent in Asia Pacific. Year-to-date sales decreased 38 percent in the Americas, 49 percent in Europe (43 percent at consistent translation rates) and 28 percent in Asia Pacific.

In the second quarter, the impacts of low volume and currency translation on operating earnings were partially offset by the impacts of lower selling-related expenses and spending reductions initiated in prior quarters. Low volume, workforce reduction costs, currency translation and increased product development expense affected year-to-date operating earnings as a percentage of sales.

Contractor

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2009	June 27, 2008	June 26, 2009	June 27, 2008
Net sales (in millions)				
Americas	$ 41.0	$ 51.4	$ 72.8	$ 93.7

Europe	14.0	24.0	24.8	42.0
Asia Pacific	5.4	6.7	10.2	12.5
Total	$ 60.4	$ 82.1	$ 107.8	$ 148.2
Operating earnings as a percentage of net sales	20%	25%	12%	23%

For the quarter, Contractor segment sales decreased 20 percent in the Americas, 42 percent in Europe (35 percent at consistent translation rates) and 18 percent in Asia Pacific. Year-to-date sales decreased 22 percent in the Americas, 41 percent in Europe (33 percent at consistent translation rates) and 18 percent in Asia Pacific.

In the second quarter, the impacts of low volume and currency translation on operating earnings were partially offset by the impacts of lower selling-related expenses and spending reductions initiated in prior quarters. Low volume, workforce reduction costs, currency translation and increased product development expense affected year-to-date operating earnings as a percentage of sales. Contractor operating results were also affected by sales, costs and expenses related to the rollout of entry-level paint sprayers to additional paint and home center stores in both 2009 and 2008.

Lubrication

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2009	June 27, 2008	June 26, 2009	June 27, 2008
Net sales (in millions)				
Americas	$ 11.8	$ 19.0	$ 24.4	$ 39.1
Europe	0.8	1.9	1.9	3.8
Asia Pacific	1.4	3.2	2.9	4.9
Total	$ 14.0	$ 24.1	$ 29.2	$ 47.8
Operating earnings as a percentage of net sales	(12)%	19%	(11)%	19%

For the quarter, Lubrication segment sales decreased 38 percent in the Americas, 58 percent in Europe (54 percent at consistent translation rates) and 56 percent in Asia Pacific. Year-to-date sales decreased 37 percent in the Americas, 50 percent in Europe (46 percent at consistent translation rates) and 41 percent in Asia Pacific.

In the second quarter, the impact of low volume on operating earnings were partially offset by the impacts of lower selling-related expenses and spending reductions initiated in prior quarters. Low volume, workforce

reduction costs and increased product development expense affected year-to-date operating earnings as a percentage of sales. Mix of products sold and costs related to discontinued products contributed to lower margin rates in the Lubrication segment.

Liquidity and Capital Resources

In the first half of 2009, the Company used cash to reduce the borrowings under its long-term line of credit by $36 million and paid dividends of $23 million. Significant uses of cash and borrowings in the first half of 2008 included $80 million for purchases and retirement of Company common stock, $35 million for a business acquisition and $23 million for payment of dividends.

Since the end of 2008, inventories have been reduced by $23 million. Accounts receivable decreased by $15 million from continuing collections and lower sales levels.

At June 26, 2009, the Company had various lines of credit totaling $281 million, of which $123 million was unused. Internally generated funds and unused financing sources are expected to provide the Company with the flexibility to meet its liquidity needs in 2009.

Outlook

Management expects that global economic conditions will continue to present a challenging operating environment for at least the rest of the year. To the extent permitted by working capital resources, management intends to continue making targeted investments in strategic operating and growth initiatives, including new product development, improving manufacturing efficiencies, expanding distribution and entering new markets.

Working capital management will continue to be a high priority for the remainder of 2009. The Company plans to further reduce inventory and continue its focus on collection of receivables over their normal cycle.
Given the uncertainty in world economies and the possibility of continued weakness in markets

served, management has contingency plans to appropriately respond to conditions as they develop.

SAFE HARBOR CAUTIONARY STATEMENT

A forward-looking statement is any statement made in this report and other reports that the Company files periodically with the Securities and Exchange Commission, or in press or earnings releases, analyst briefings and conference calls, which reflects the Company's current thinking on market trends and the Company's future financial performance at the time they are made. All forecasts and projections are forward-looking statements.

The Company desires to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 by making cautionary statements concerning any forward-looking statements made by or on behalf of the Company. The Company cannot give any assurance that the results forecasted in any forward-looking statement will actually be achieved. Future results could differ materially from those expressed, due to the impact of changes in various factors. These risk factors include, but are not limited to: economic conditions in the United States and other major world economies, currency fluctuations, political instability, changes in laws and regulations, and changes in product demand. Please refer to Item 1A of, and Exhibit 99 to, the Company's Annual Report on Form 10-K for fiscal year 2008 for a more comprehensive discussion of these and other risk factors.

Investors should realize that factors other than those identified above and in Item 1A and Exhibit 99 might prove important to the Company's future results. It is not possible for management to identify each and every factor that may have an impact on the Company's operations in the future as new factors can develop from time to time.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes related to market risk from the disclosures made in the Company's 2008 Annual Report on Form 10-K.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

As of the end of the fiscal quarter covered by this report, the Company carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures. This evaluation was done under the supervision and with the participation of the Company's President and Chief Executive Officer, the Chief Financial Officer and Treasurer, the Vice President and Controller, and the Vice President, General Counsel and Secretary.
Based upon that evaluation, they concluded that the Company's disclosure controls and procedures are effective in gathering, analyzing and disclosing information needed to satisfy the Company's disclosure obligations under the Exchange Act.

Changes in internal controls

During the quarter, there was no change in the Company's internal control over financial reporting that has materially affected or is reasonably likely to materially affect the Company's internal control over financial reporting.

PART II OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes to the Company's risk factors from those disclosed in the Company's 2008 Annual Report on Form 10-K.

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

Issuer Purchases of Equity Securities

On September 28, 2007, the Board of Directors authorized the Company to purchase up to 7,000,000 shares of its outstanding common stock, primarily through open-market transactions. This authorization expires on September 30, 2009.

In addition to shares purchased under the Board authorizations, the Company purchases shares of common stock held by employees who wish to tender owned shares to satisfy the exercise price or tax withholding on option exercises.

Information on issuer purchases of equity securities follows:

Period	Total Number of Shares Purchased	Average Price Paid per Share		Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (at end of period)
Mar 28, 2009 – Apr 24, 2009	-	$	-	-	3,068,234
Apr 25, 2009 – May 22, 2009	6,290	$	22.57	-	3,068,234
May 23, 2009 – Jun 26, 2009	-	$	-	-	3,068,234

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

At the Annual Meeting of Shareholders held on April 24, 2009, three directors were elected to the Board of Directors with the following votes:

	For	Withheld
William J. Carroll	51,744,263	1,246,050
Jack W. Eugster	51,737,026	1,253,287
R. William Van Sant	51,760,317	1,229,997

At the same meeting, the appointment of Deloitte & Touche LLP as the Independent Registered Public Accounting

Firm was ratified, with the following votes:

For	Against	Abstentions
52,101,637	842,984	45,691

Item 6. Exhibits

31.1 Certification of President and Chief Executive Officer pursuant to Rule 13a-14(a).

31.2 Certification of Chief Financial Officer and Treasurer pursuant to Rule 13a-14(a).

32 Certification of the President and Chief Executive Officer and the Chief Financial Officer and Treasurer pursuant to Section 1350 of Title 18, U.S.C.

SIGNATURES

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.

GRACO INC.

Date:	By:	/s/Patrick J. McHale Patrick J. McHale President and Chief Executive Officer *(Principal Executive Officer)*
Date:	By:	/s/James A. Graner James A. Graner Chief Financial Officer and Treasurer *(Principal Financial Officer)*
Date:	By:	/s/Caroline M. Chambers Caroline M. Chambers Vice President and Controller *(Principal Accounting Officer)*