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MERCATOR SOFTWARE INC
Form 10-Q
May 15, 2001

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (D) OF THE SECURITIES EXCHANGE ACT OF 1934. For The Quarterly Period Ended March 31, 2001

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (D) OF THE SECURITIES EXCHANGE ACT OF 1934. For Transition Period From _____ To _____.

Commission File Number: 0-22667

MERCATOR SOFTWARE, INC.
(Exact Name as Specified in its Charter)

| | |
|---|--|
| Delaware | 06-1132156 |
| (State or other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification Number) |

| | |
|--------------------------------|------------|
| 45 Danbury Road | 06897 |
| Wilton, Connecticut | (Zip Code) |
| (Address of Principal Offices) | |

(203) 761-8600
(Registrant's Telephone Number Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 and 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

As of May 11, 2001, the Registrant had 30,362,592 shares of Common Stock, \$.01 par value outstanding.

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MERCATOR SOFTWARE, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

| | March 31, 2001 ---- | December 2000 ---- |
|--|---------------------------|--------------------------|
| | (unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 12,879 | \$ 18,3 |
| Marketable securities | 581 | 3,4 |
| Accounts receivable, less allowances of \$3,702 and \$3,616 | 33,547 | 38,9 |
| Deferred tax assets | 3,181 | 3,1 |
| Prepaid expenses and other current assets | 3,827 | 3,6 |
| | ----- | ----- |
| Total current assets | 54,015 | 67,4 |
| Furniture, fixtures and equipment, net | 10,721 | 10,0 |
| Intangible assets, net | 74,634 | 81,5 |
| Restricted collateral deposits and other assets | 3,557 | 1,8 |
| | ----- | ----- |
| Total assets | \$ 142,927 ===== | \$ 160,8 ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |

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| | | |
|---|------------|----------|
| Accounts payable | \$ 9,233 | \$ 6,7 |
| Accrued expenses and other current liabilities | 13,855 | 19,5 |
| Current portion of deferred revenue | 20,245 | 17,8 |
| | ----- | ----- |
| Total current liabilities | 43,333 | 44,0 |
| Long-term deferred tax liability | 3,777 | 3,7 |
| Deferred revenue, less current portion | 1,058 | 9 |
| Other long term liabilities | 637 | 6 |
| | ----- | ----- |
| Total liabilities | 48,805 | 49,4 |
| Stockholders' equity: | | |
| Convertible preferred stock (\$.01 par value; authorized 5,000,000 shares, no shares issued and outstanding) | -- | |
| Common stock (190,000,000 shares authorized, \$.01 par value; 30,347,099 and 29,846,902 shares issued and outstanding) | 304 | 2 |
| Additional paid-in capital | 231,854 | 228,0 |
| Accumulated deficit | (135,448) | (114,7 |
| Accumulated other comprehensive loss | (2,263) | (1,7 |
| Deferred compensation | (325) | (4 |
| | ----- | ----- |
| Total stockholders' equity | 94,122 | 111,4 |
| | ----- | ----- |
| Total liabilities and stockholders' equity | \$ 142,927 | \$ 160,8 |
| | ===== | ===== |

See accompanying notes to condensed consolidated financial statements.

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MERCATOR SOFTWARE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(unaudited)

| | Three Months Ended March 31, | |
|------------------------|---------------------------------|-----------|
| | 2001 | 2000 |
| | ---- | ---- |
| Revenues: | | |
| Software licensing | \$ 11,522 | \$ 18,307 |
| Services | 8,666 | 6,597 |
| Maintenance | 7,946 | 6,348 |
| | ----- | ----- |
| Total revenues | 28,134 | 31,252 |
| | ----- | ----- |
| Cost of revenues: | | |
| Software licensing | 237 | 285 |
| Services | 7,373 | 5,523 |
| Maintenance | 1,789 | 1,604 |
| | ----- | ----- |
| Total cost of revenues | 9,399 | 7,412 |
| | ----- | ----- |
| Gross profit | 18,735 | 23,840 |

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| | | |
|---|-------------|-------------|
| Operating expenses: | | |
| Product development | 5,246 | 5,089 |
| Selling and marketing | 16,808 | 13,782 |
| General and administrative | 8,596 | 3,530 |
| Amortization of intangibles | 6,944 | 10,977 |
| | ----- | ----- |
| Total operating expenses | 37,594 | 33,378 |
| | ----- | ----- |
| Operating loss | (18,859) | (9,538) |
| Other income, net | 38 | 154 |
| | ----- | ----- |
| Loss before income taxes | (18,821) | (9,384) |
| Provision for income taxes | 1,867 | 2,113 |
| | ----- | ----- |
| Net loss | \$ (20,688) | \$ (11,497) |
| | ===== | ===== |
| Net loss per share - Basic and Diluted | \$ (0.69) | \$ (0.41) |
| Weighted average number of common and common equivalent shares outstanding -Basic and Diluted | 29,989 | 28,207 |

See accompanying notes to condensed consolidated financial statements.

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MERCATOR SOFTWARE, INC.
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(In thousands)
(unaudited)

| | Three Months Ended March 31, | |
|---|---------------------------------|----------|
| | 2001 | 2000 |
| | ---- | ---- |
| Cash flows from operating activities: | | |
| Net cash (used in) provided by operating activities | \$ (8,083) | \$ 3,863 |
| Cash flows from investing activities: | | |
| Purchase of furniture fixtures and equipment | (1,875) | (2,035) |
| Sales of marketable securities | 2,839 | 1,541 |
| Restricted Collateral Deposits | (1,554) | -- |
| Other | -- | (56) |
| | ----- | ----- |
| Net cash used in investing activities | (590) | (550) |
| | ----- | ----- |
| Cash flows from financing activities: | | |
| Payments under capital leases | (113) | -- |

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| | | |
|--|-----------|-----------|
| Proceeds from exercise of stock options | 149 | 1,993 |
| Proceeds from issuance of stock under employee stock purchase plan | 1,375 | 1,190 |
| Proceeds from issuance of shares of restricted stock | 2,000 | -- |
| | ----- | ----- |
| Net cash provided by financing activities | 3,411 | 3,183 |
| | ----- | ----- |
| | | |
| Effect of exchange rate changes on cash | (186) | (556) |
| | ----- | ----- |
| | | |
| Net change in cash | (5,448) | 5,940 |
| Cash at beginning of period | 18,327 | 9,237 |
| | ----- | ----- |
| | | |
| Cash at end of period | \$ 12,879 | \$ 15,177 |
| | ===== | ===== |
| | | |
| Supplemental information: | | |
| Cash paid for: | | |
| Interest | \$ 91 | \$ 25 |
| Income taxes | \$ 36 | \$ 346 |

See accompanying notes to consolidated condensed financial statements.

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MERCATOR SOFTWARE, INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(UNAUDITED)

(1) UNAUDITED INTERIM FINANCIAL STATEMENTS

The accompanying consolidated interim condensed financial statements contained herein are unaudited, but, in the opinion of management, include all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of financial position, results of operations and cash flows for the periods presented. Results of operations for the periods presented herein are not necessarily indicative of results of operations for the entire year.

Reference should be made to Mercator Software Inc.'s ("Mercator" or the "Company") 2000 Annual Report on Form 10-K, which includes audited financial statements for the year ended December 31, 2000.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the Securities and Exchange Commission's rules and regulations.

(2) STOCK ACTIVITIES

In January, 2001 the Company issued for fair market value 228,180 shares of its restricted common stock, \$.01 par value, to Mitsui & Co., Ltd. for \$2.0 million in cash. The Company anticipates forming a joint venture with Mitsui to market its products in Japan.

(3) COMPREHENSIVE INCOME

Mercator applies the provisions of SFAS No. 130, "Reporting Comprehensive Income," which requires Mercator to report comprehensive income in its financial statements, in addition to its net income. Comprehensive income (loss) includes

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all changes in equity during a period from non owner sources. Mercator's comprehensive income consists of net income (loss) and foreign currency translation adjustments. Total comprehensive (loss) was (\$21.2) million and (\$12.1) million for the three months ended March 31, 2001 and 2000, respectively.

(4) EARNINGS PER SHARE

The Company determines earnings per share in accordance with the provisions of SFAS No. 128, "Earnings Per Share", which requires the calculation of basic and diluted net income per share. Basic earnings per share is computed based upon the weighted average number of common shares outstanding. Diluted earnings per share is computed based upon the weighted average number of common shares outstanding increased for any dilutive effects of options, warrants, and convertible securities.

Diluted loss per share has not been presented separately for the three months ended March 31, 2001 and 2000, as the outstanding stock options and warrants, representing an aggregate of 1,221,919 and 4,193,370 shares of common stock equivalents, respectively, are anti-dilutive.

(5) DERIVATIVE FINANCIAL INSTRUMENTS

On January 1, 2001, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative instruments and hedging activities. SFAS No. 133, as amended by SFAS 137 (deferral of effective date) and SFAS 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities", requires that all derivatives be recognized as either assets or liabilities at fair value. Derivatives that are not hedges must be adjusted to fair value through income. If the derivative is a hedge, depending on the nature of the hedge, changes in fair value will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings, or recognized in other comprehensive income until the hedged item is recognized in earnings.

The Company has not entered into derivative contracts and does not have near term plans to enter into such contracts; accordingly, the adoption of these pronouncements has not had a material effect on the financial statements.

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(6) SEGMENT INFORMATION

The Company reports its segment information in accordance with the SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information". SFAS No. 131 establishes standards for the way that public business enterprises report information about operating segments. It also establishes standards for related disclosures about products and services. Reportable segment information is determined based on management defined operating segments used to make operating decisions and assess financial performance.

Prior to January 1, 2001 the Company classified its business activities into two reportable segments: Domestic and International. Effective January 1, 2001, the Company restructured its operations into three reportable segments: Americas (North America, Central and South America) including corporate, EMEA (Europe, Middle East & Africa) and APAC (Asia Pacific). Prior period segment data has been restated to conform to this presentation. Information regarding the Company's operations in these three segments are set forth below (in thousands). There are no significant corporate overhead allocations or intersegment sales or transfers between the segments for the periods presented.

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| | Quarter Ended March 31, (unaudited) | |
|--|--|-------------|
| | 2001 | 2000 |
| | ---- | ---- |
| Revenues: | | |
| Americas | \$ 16,052 | \$ 19,016 |
| EMEA | 11,272 | 11,145 |
| APAC | 810 | 1,091 |
| | ----- | ----- |
| Total | \$ 28,134 | \$ 31,252 |
| | ===== | ===== |
| Operating income (loss) before amortization of intangibles: | | |
| Americas (including corporate) | \$ (10,035) | \$ (380) |
| EMEA | (1,352) | 1,474 |
| APAC | (528) | 345 |
| | ----- | ----- |
| Total | (11,915) | 1,439 |
| Amortization of intangibles | (6,944) | (10,977) |
| Other income, net | 38 | 154 |
| Provision for taxes | 1,867 | 2,113 |
| | ----- | ----- |
| Net loss | \$ (20,688) | \$ (11,497) |
| | ===== | ===== |

| | As of March 31, (unaudited) | |
|---------------|--------------------------------|------------|
| | 2001 | 2000 |
| | ---- | ---- |
| Total assets: | | |
| Americas | \$42,284 | \$ 101,949 |
| EMEA | 97,170 | 119,204 |
| APAC | 3,473 | 1,739 |
| | ----- | ----- |
| Total | \$ 142,927 | \$ 222,892 |
| | ===== | ===== |

(7) COMMITMENTS AND CONTINGENCIES

The Company and its former chief executive officer have been named as defendants in several private securities class action lawsuits. The complaints allege violations of United States federal securities law. Mercator believes that the allegations in the complaints are without merit and intends to contest them vigorously. However, there can be no guarantee as to the ultimate outcome as to these pending litigation matters. See Item 1 in Part II of this filing for further information.

ITEM 2

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

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The following management's discussion and analysis of financial condition and results of operations contains forward-looking statements that involve risks and uncertainties. When used in the filing, the words "intend," "anticipate," "believe," "estimate," "plan" and "expect" and similar expressions as they relate to Mercator are included to identify forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors including those set forth under "Factors That may Affect Future Results" and elsewhere in this document.

OVERVIEW

The Company was incorporated in Connecticut in 1985 as TSI International Software Ltd. and reincorporated in Delaware in September 1993. We completed our initial public offering in July 1997 and a secondary offering in June 1998. We changed our name to Mercator Software, Inc. effective April 3, 2000.

Mercator provides business integration solutions to customers around the world. Our revenues are derived principally from three sources: (i) license fees for the use of our software products, (ii) fees for consulting services and training and (iii) fees for maintenance and technical support.

We recognize license fee revenue when persuasive evidence of an agreement exists, delivery has occurred, the fee is fixed and determinable, and the fee is collectible. Revenue from professional service arrangements is recognized on either a time and materials or percentage of completion basis as the services are performed and amounts due from customers are deemed collectible and contractually nonrefundable. Revenues from fixed price service agreements are recognized on a percentage of completion basis in direct proportion to the services provided. Maintenance contract revenues are recognized ratably over the terms of the contracts, which are generally for one year. The unrecognized portion of maintenance revenue is classified as deferred maintenance revenue in the accompanying consolidated balance sheets. For additional information regarding our revenue recognition policies, please refer to the "Summary of Significant Accounting Policies" included in the notes to consolidated financial statements in our Form 10K Annual Report for the year ended December 31, 2000.

We intend to continue to increase the scope of service offerings insofar as it supports the generation of license revenues from our products. Although not indicative in our current quarter results, we believe that software licensing revenue will continue to account for a larger portion of total revenues than services and maintenance revenues.

Our products can be used by information technology professionals, as well as value added resellers, independent software vendors, software integrators or other third parties who resell, embed or otherwise bundle our products with their products. License fee revenues are derived from direct licensing of software products through our direct sales force and indirect third parties.

The size of orders can range from a few thousand dollars to over \$3.0 million per order. The loss or delay of large individual orders, therefore, can have a significant impact on revenue and other quarterly results. In addition, we generally recognize a substantial portion of our quarterly software licensing revenues in the last month of each quarter, and as a result, revenue for any particular quarter may be difficult to predict in advance. Because operating expenses are relatively fixed, a delay in the recognition of revenue from a limited number of license transactions could cause significant variations in operating results from quarter to quarter and could result in significant losses. To the extent such expenses precede, or are not subsequently followed by increased revenue, operating results would be materially and adversely affected. As a result of these and other factors, operating results for any quarter are

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subject to variation, and period-to-period comparisons of results of operations are not necessarily meaningful and should not be relied upon as indications of future performance.

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RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, the percentage of total revenues represented by certain items from our statements of operations:

| | Three Months Ended | |
|---|--------------------|---------|
| | ----- | |
| | March 31, | |
| | ----- | |
| | 2001 | 2000 |
| | ----- | ----- |
| Revenues: | | |
| Software licensing | 41.0% | 58.6% |
| Services | 30.8 | 21.1 |
| Maintenance | 28.2 | 20.3 |
| | ----- | ----- |
| Total revenues | 100.0 | 100.0 |
| | ----- | ----- |
| Cost of revenues: | | |
| Software licensing | .8 | .9 |
| Services | 26.2 | 17.7 |
| Maintenance | 6.4 | 5.1 |
| | ----- | ----- |
| Total cost of revenues | 33.4 | 23.7 |
| | ----- | ----- |
| Gross profit | 66.6 | 76.3 |
| | ----- | ----- |
| Operating expenses: | | |
| Product development | 18.6 | 16.3 |
| Selling and marketing | 59.7 | 44.1 |
| General and administrative | 30.6 | 11.3 |
| Amortization of intangibles | 24.7 | 35.1 |
| | ----- | ----- |
| Total operating expenses | 133.6 | 106.8 |
| | ----- | ----- |
| Operating loss | (67.0) | (30.5) |
| Other income net | 0.1 | 0.5 |
| | ----- | ----- |
| Loss before income taxes | (66.9) | (30.0) |
| Provision for income taxes | 6.6 | 6.8 |
| | ----- | ----- |
| Net Loss | (73.5)% | (36.8)% |
| | ===== | ===== |
| Gross profit (as percent of related revenue): | | |
| Software licensing | 97.9% | 98.4% |
| Services | 14.9% | 16.2% |
| Maintenance | 77.5% | 74.7% |

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THE QUARTER ENDED MARCH 31, 2001 COMPARED WITH QUARTER ENDED MARCH 31, 2000

During the first quarter of 2001 we incurred a net (loss) of (\$20.7 million) compared to a net (loss) of (\$11.5 million) in the first quarter of 2000. First quarter operating (loss) was (\$18.9 million) in 2001 compared to (\$9.5 million) in 2000. Our operating income (loss) excluding amortization was (\$11.9 million) in the first quarter of 2001 compared to \$1.4 million in the first quarter of 2000. This \$13.3 million decrease was the result of a \$5 million decrease in gross profit, increased selling and marketing expenses of \$3 million and increased general and administrative expenses of \$5 million. The decline in gross profit was primarily due to a \$6.8 million decline in license revenues. Most of the increase in selling and marketing expenses was incurred in anticipation of higher revenues for the first quarter of 2001. Our general and administrative expenses reflect certain incremental expenses and reorganization costs which continued from the third and fourth quarters of 2000. As discussed below, in April 2001 we eliminated 170 full-time positions to lower our operating costs.

REVENUES

Total Revenues. Our revenues are derived principally from three sources: (i) license fees for the use of our software products, (ii) fees for consulting services and training and (iii) fees for maintenance and technical support. Total revenues decreased 10% to \$28.1 million in the first quarter of 2001 from \$31.3 million in the same period in 2000.

Software Licensing. Total software licensing revenues decreased 37% from \$18.3 million for the three months ended March 31, 2000 to \$11.5 million for the three months ended March 31, 2001. Weak economic conditions and customers delaying purchasing decisions on larger deals negatively impacted software licensing revenues in each region. Americas' licensing revenues decreased 42% from \$11.3 million to \$6.6 million, EMEA licensing revenues decreased 26% from \$6.3 million to \$4.7 million and APAC licensing revenues decreased 63% from \$731,000 to \$269,000.

Services. Services revenues increased 31% from \$6.6 million for the three months ended March 31, 2000 to \$8.7 million for the three months ended March 31, 2001. We continued to provide consulting and training services to our established customer base in the Americas, but realized stronger increases in services revenues in EMEA and APAC as a consequence of building the Mercator software customer base in these regions during 2000. Americas' services revenues increased 16% from \$3.8 million to \$4.4 million, EMEA services revenues increased 49% from \$2.7 million to \$4.0 million and APAC services revenues increased 98% from \$140,000 to \$277,000.

Maintenance. Maintenance revenues increased 25% from \$6.3 million for the three months ended March 31, 2000 to \$7.9 million for the three months ended March 31, 2001. This growth is consistent with the growth in the worldwide customer base and the related renewals of annual maintenance contracts. Americas' maintenance revenues increased 29% from \$3.9 million to \$5.1 million, EMEA maintenance revenues increased 18% from \$2.2 million to \$2.6 million and APAC maintenance revenues increased 20% from \$220,000 to \$263,000.

COST OF REVENUES

Cost of software licensing revenues consists primarily of CD-ROMs, manuals, distribution costs and the cost of third-party software that we resell. Cost of services consists primarily of personnel-related and travel costs in providing

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consulting and training to customers. Cost of maintenance revenues consists primarily of personnel-related and communication costs in providing maintenance and technical support to customers.

Gross margin on software licensing revenues is higher than gross margins on services and maintenance revenues reflecting the low materials, packaging and other costs of software products compared with the relatively high personnel costs associated with providing consulting and training services, maintenance and technical support. Cost of services also varies based upon the mix of consulting and training services.

Cost of Software Licensing. Total software licensing costs decreased 17% from \$285,000 for the three months ended March 31, 2000 to \$237,000 for the three months ended March 31, 2001. This decrease was the result of lower delivery costs connected with fewer software shipments and expanded electronic transmission of our software over the internet. Despite the decline in these costs, software licensing gross margin remained constant at 98% for the three months ended March 31, 2000 and March 31, 2001.

Cost of Services. Total cost of services increased 33% from \$5.5 million for the three months ended March 31, 2000 to \$7.4 million for the three months ended March 31, 2001 consistent with the 31% increase in services revenues previously noted. Total services gross margin decreased marginally from 16% for the three months ended March 31, 2000 to 15% for the three months ended March 31, 2001. Services gross margin for Americas decreased from 17% to 4% due to increased recruiting and training costs as well as

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lower initial productivity related to new services personnel and revenue reserves related to certain contract disputes. Services gross margin for EMEA and APAC increased from 15% to 26% due to increased utilization of services personnel and increased average billing rates.

Cost of Maintenance. Total cost of maintenance increased 12% from \$1.6 million for the three months ended March 31, 2000 to \$1.8 million for the three months ended March 31, 2001 as we added resources to support our increased customer base worldwide. Total maintenance gross margin increased marginally from 75% for the three months ended March 31, 2000 to 77% for the three months ended March 31, 2001. Maintenance gross margin increased from 73% to 79% in the Americas, decreased from 79% to 74% in EMEA and increased from 63% to 87% in APAC.

OPERATING EXPENSES

Product Development. Product development expenses include expenses associated with the development of new products and enhancements to existing products. These expenses consist primarily of salaries, recruiting, other personnel-related costs, depreciation of development equipment, supplies, travel, allocated facilities and allocated communication costs.

Total product development expenses increased 3% from \$5.1 million for the three months ended March 31, 2000 to \$5.3 million for the three months ended March 31, 2001. Americas' development expenses increased 7% from \$3.4 million to \$3.7 million, EMEA development expenses decreased 5% from \$1.7 million to \$1.6 million and APAC had no development expenses in either year.

We believe that a significant level of research and development expenditures is required to remain competitive. Accordingly, we expect to continue to devote substantial resources to research and development. To date, all research and development expenditures have been expensed as incurred.

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Selling and Marketing. Selling and marketing expenses consist of sales and marketing personnel costs, including sales commissions, recruiting, travel, advertising, public relations, seminars, trade shows, product literature, allocated facilities and allocated communications costs.

Total selling and marketing expenses increased 22% from \$13.8 million for the three months ended March 31, 2000 to \$16.8 million for the three months ended March 31, 2001. This increase is due to an increase in the number of sales personnel, especially in EMEA, and related travel costs partially offset by lower marketing costs. Americas' selling and marketing expenses increased 9% from \$9.5 million to \$10.4 million, EMEA selling and marketing expenses increased 53% from \$3.9 million to \$6.0 million and APAC selling and marketing expenses increased 21% from \$346,000 to \$420,000. We expect selling and marketing expenses to generally decrease in the future as a percentage of revenues as a result of our April 2001 restructuring.

General and Administrative. General and administrative expenses consist primarily of salaries, recruiting, and other personnel related expenses for the Company's administrative, executive, and finance personnel as well as outside legal, consulting, tax services and audit fees.

Total general and administrative expenses increased 144% from \$3.5 million for the three months ended March 31, 2000 to \$8.6 million for the three months ended March 31, 2001. This increase is primarily due to increased headcount, turnover costs related to senior management, incremental legal, accounting and consulting fees as well as other administrative costs incurred to support our worldwide growth. Americas' general and administrative expenses, which includes corporate headquarters costs, increased 206% from \$2.1 million to \$6.6 million, EMEA general and administrative expenses increased 25% from \$1.2 million to \$1.5 million and APAC general and administrative expenses increased 203% from \$147,000 to \$445,400. We expect general and administrative expenses to generally decrease in the future as a percentage of revenues as a result of our April 2001 restructuring.

Amortization of Intangibles. Intangible assets are comprised of the excess of the purchase price and related costs of an acquired business over the value assigned to tangible assets. The acquisitions we made in 1998 and 1999 were accounted for under the purchase method of accounting. The purchase prices were allocated to the tangible and identifiable intangible assets based on their estimated fair values with any excess designated as goodwill. Intangible assets, including goodwill, are amortized over their estimated useful lives, which range from three to five years.

Amortization expense decreased from \$10.9 million for the three months ended March 31, 2000 to \$6.9 million for the three months ended March 31, 2001, as a result of the intangibles impairment charge we recorded in the fourth quarter of 2000. As of March 31, 2001 Mercator had net intangible assets of \$74.6 million as compared to \$142.3 million one year ago. The \$74.6 million net intangible asset balance at March 31, 2001 will be fully amortized by February 2004.

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OTHER INCOME (EXPENSE), NET

Total other income (expense), net decreased from \$154,000 for the three months ended March 31, 2000 to \$38,000 for the three months ended March 31, 2001, primarily due to the conversion of interest bearing investments to cash to support operations as well as an increase in borrowing costs due to the expensing of origination fees relating to the Fleet Bank \$20 million credit line facility that was terminated in March 2001.

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TAXES

The provision for income taxes was \$1.9 million for the quarter ended March 31, 2001 as compared to \$2.1 million for the same period in 2000. The provision for income taxes is based on the anticipated effective tax rates and taxable income for the full year taking into account each jurisdiction in which the Company operates. The difference between the company's effective tax rate and the U.S. statutory rate is primarily attributable to \$5.8 million of non-deductible goodwill amortization and the effect of certain expected foreign taxable losses for the quarter ended March 31, 2001 and \$8.9 million of non-deductible goodwill amortization for the quarter ended March 31, 2000.

LIQUIDITY AND CAPITAL RESOURCES

On March 31, 2001 we had net working capital of \$10.7 million, which included cash and marketable securities of \$13.5 million compared to net working capital of \$39.7 million, including cash and marketable securities of \$19.3 million, at March 31, 2000. Net working capital at December 31, 2000 was \$23.4 million including cash and marketable securities of \$21.7 million. The \$13 million decrease in working capital from December 31, 2000 was caused primarily by an \$8 million decrease in cash and marketable securities and a \$5 million decrease in net accounts receivable.

Net accounts receivable were \$33.5 million at March 31, 2001 compared to \$40.2 million at March 31, 2000. Net accounts receivable decreased \$5.4 million from \$38.9 million at December 31, 2000 due primarily to an \$11 million decrease in consecutive quarter revenues partially offset by a \$2.5 million increase in deferred revenue during the quarter as well as the timing of collections from customers because of the softening economy. Consequently, the number of days sales in net accounts receivable increased from 89 at December 31, 2000 to 107 at March 31, 2001.

Operating activities used net cash of \$8.1 million during the quarter ended March 31, 2001 compared to providing net cash of \$3.9 million during the quarter ended March 31, 2000. Of the \$21 million net loss for the quarter ended March 31, 2001, \$8 million resulted from non-cash expenses, primarily intangibles amortization and depreciation. The cash used to fund the remaining \$13 million loss was offset by cash provided by a \$2.5 million increase in deferred revenue and a \$2.5 million increase in accounts payable. For the quarter ended March 31, 2000 the net loss of \$11.5 million was caused primarily by \$12 million of intangibles amortization and depreciation and a \$2 million tax provision, neither of which consumed any cash.

Investing activities consumed cash of \$590,000 during the quarter ended March 31, 2001 compared to \$550,000 during the quarter ended March 31, 2000. 2001 activities included a \$1.9 million net investment in furniture, fixtures and equipment, a \$1.5 million increase in the restricted collateral deposit in connection with the new headquarters facility lease partially offset by a \$2.8 million liquidation of investments in marketable securities. 2000 activities included a \$2.0 million net investment in furniture, fixtures and equipment offset by a \$1.5 million liquidation of investments in marketable securities.

Financing activities generated cash of \$3.4 million during the quarter ended March 31, 2001 compared to \$3.2 million during the quarter ended March 31, 2000. In the quarter ended March 31, 2001 we generated cash of \$2 million from the sale of restricted common stock and \$1.4 million from employee stock plan purchases. In the quarter ended March 31, 2000 we generated cash of \$2.0 million from employee stock option exercises and \$1.2 million from employee stock plan purchases.

In March 2001 the \$20 million line of credit agreement with Fleet Bank was terminated. Since inception no amounts were borrowed under this agreement.

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Capital expenditures have been, and future capital expenditures are anticipated to be primarily for facilities, computer equipment and software to support the expansion our operations. Certain computer equipment used in development activities may be available through operating leases. In January 2001, pursuant to the new headquarters lease agreement, we increased the letter of credit to \$2.5 million and the related restricted collateral deposit to \$3.0 million. As of March 31, 2001 we had commitments for capital expenditures of approximately \$1.0 million through September 2001.

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We believe our current cash and cash equivalent balances, combined with net cash generated from operations should be sufficient to meet anticipated needs for working capital and capital expenditures by December 31, 2001. However, due in part to first quarter revenue softness, there could be a shortfall in cash during the year. Accordingly, we signed a commitment letter with Silicon Valley Bank in April 2001 for a \$15 million line of credit secured by certain receivables. In addition, on April 30, 2001 we completed a strategic restructuring and reorganization, which eliminated 170 full-time positions. These staffing reductions will result in approximately \$2 million in severance costs for the quarter ending June 30, 2001, but are designed to reduce cash used in operations by approximately \$1.5 million per month beginning in July 2001. We also believe the need for future capital expenditures will be reduced as we upgrade older equipment with newer equipment available from the reorganization. We are currently seeking to sublease the new headquarters space and other surplus office space to third parties.

We are exploring other financing alternatives in the event cash needs are greater than that which is available through operations and the credit line. However, any projections of future cash needs and cash flows are subject to substantial uncertainty. Therefore, there can be no assurance that such financing will be available in amounts or on terms acceptable to us, or at all. The sale of additional equity or equity-related securities would result in additional dilution to our stockholders.

CONVERSION TO A SINGLE EUROPEAN CURRENCY

We generate revenues in a number of foreign countries. However, as the majority of foreign license contracts are denominated in US dollars, we do not expect conversion to a single European currency to have a material impact on our financial results.

FACTORS THAT MAY AFFECT FUTURE RESULTS

Our quarterly and annual operating results are volatile and difficult to predict and may cause our stock price to fluctuate.

Our quarterly and annual operating results have varied significantly in the past and are expected to do so in the future. We believe that you should not rely on period-to-period comparisons of our results of operations, as they are not necessarily indications of our future performance. In some future periods, our results of operations may be below the expectation of public market analysts and investors. In this case, the price of our common stock would likely decline.

Our revenues and results of operations are difficult to forecast and depend on a variety of factors. These factors include the following:

- . personnel changes, our ability to attract and retain qualified sales, professional services and research and development personnel and the rate at which these personnel become productive;

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- . general economic conditions;
- . the size, timing and terms of individual license transactions;
- . the sales cycle for our products;
- . demand for and market acceptance of our products and related services, particularly our Mercator products;
- . our ability to expand, and market acceptance of, our services business;
- . the timing of our expenditures in anticipation of product releases or increased revenue;
- . the timing of product enhancements and product introductions by us and our competitors;
- . market acceptance of enhanced versions of our existing products and of new products;
- . changes in pricing policies by our competitors and us;
- . variations in the mix of products and services sold by us;
- . the mix of channels through which our products and services are sold;

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- . our success in penetrating international markets; and
- . the buying patterns and budgeting cycles of customers.

We have historically derived a substantial portion of our revenues from the licensing of our software products, and we anticipate that this trend will continue for the foreseeable future. Software license revenues are difficult to forecast for a number of reasons, including the following:

- . we typically do not have a material backlog of unfilled orders, and revenues in any quarter substantially depend on orders booked and shipped in that quarter;
- . the length of the sales cycles for our products can vary significantly from customer to customer and from product to product and can be as long as nine months or more;
- . the terms and conditions of individual license transactions, including prices and discounts, are often negotiated based on volumes and commitments, and may vary considerably from customer to customer; and
- . we have generally recognized a substantial portion of our quarterly software licensing revenues in the last month of each quarter.

Accordingly, the cancellation or deferral of even a small number of purchases of our products could harm our business.

We have taken and expect to continue to take remedial measures to address the recent slowdown in the market for our Mercator products which could have long-term effects on our business.

We have taken and expect to continue to take remedial measures to address the

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recent slowdown in the market for our Mercator products. In particular, we have reduced our workforce and reduced our planned capital expenditure and expense budgets. These measures will reduce our expenses in the face of decreased revenues due to decreased customer orders. However, each of these measures could have long-term effects on our business by reducing our pool of technical talent, decreasing or slowing improvements in our products, and making it more difficult for us to respond to customers.

Investors, customers and vendors may react adversely to change in our company.

Our success depends in large part on the support of investors, key customers and vendors who may react adversely to changes in our company since the restatement of our first quarter 2000 earnings and the adjustment to previously disclosed second quarter 2000 results. Many members of our senior management have joined us since August 2000. It will take time and resources for these individuals to effect change within our organization and during this period our vendors and customers may re-examine their willingness to do business with us. If we are unable to retain and attract our existing and new customers and vendors, our business, operating results and financial condition could be materially adversely affected.

Our future success depends on retaining our key personnel and attracting and retaining additional highly qualified employees.

Our future success depends in large part on the retention of our key sales, professional services and research and development personnel, as well as senior management. Other than the Chairman and Chief Executive Officer, the Vice-Chairman and the Chief Financial Officer and one of our area vice presidents, all employees are employed at-will and we have no fixed-term employment agreements with our employees, which prevents them from terminating their employment at any time. The loss of the services of any of one or more of our key employees could harm our business.

Our future success also depends on our ability to attract, train and retain highly qualified sales, research and development, professional services and managerial personnel, particularly sales, professional services and research and development personnel with expertise in enterprise resource planning systems. Competition for these personnel is intense. We may not be able to attract, assimilate or retain qualified personnel. We have at times experienced, and we continue to experience, difficulty in recruiting qualified sales and research and development personnel, and we anticipate these difficulties will continue in the future. Furthermore, we have in the past experienced, and in the future we expect to continue to experience, a significant time lag between the date sales, research and development and professional services personnel are hired and the date these employees become fully productive.

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It would be difficult for us to adjust our spending if we experience any revenue shortfalls.

Our future revenues will also be difficult to predict and we could fail to achieve our revenue expectations. Our expense levels are based, in part, on our expectation of future revenues, and expense levels are, to a large extent, fixed in the short term. We may be unable to adjust spending in a timely manner to compensate for any unexpected revenue shortfall. If revenue levels are below expectations for any reason, our operating results and cash flows are likely to be harmed. Net income may be disproportionately affected by a reduction in revenue because large portions of our expenses are related to headcount that cannot be easily reduced without harming our business.

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We may experience seasonal fluctuations in our revenues or results of operations.

It is not uncommon for software companies to experience strong fourth quarters followed by weaker first quarters, in some cases with sequential declines in revenues or operating profit. We believe that many software companies exhibit this pattern in their sales cycles primarily due to customers' buying patterns and budget cycles. We may display this pattern in future years.

We are exposed to general economic conditions.

As a result of recent unfavorable economic conditions and reduced capital spending, software licensing revenues have declined as a percentage of our total revenues. In particular, sales to e-commerce and internet businesses, value added resellers and independent software vendors were impacted during the first fiscal quarter of 2001. If the economic conditions in the United States worsen, or if a wider global economic slowdown occurs, we may experience a material adverse impact on our business, operating results, and financial condition.

We depend on the sales of our Mercator products and related services.

We first introduced our Mercator products in 1993. In recent years, a significant portion of our revenue has been attributable to licenses of our Mercator products and related services, and we expect that revenue attributable to our Mercator products and related services will continue to represent a significant portion of our total revenue for the foreseeable future. Accordingly, our future operating results significantly depend on the market acceptance and growth of our Mercator product line and enhancements of these products and services. Market acceptance of our Mercator product line may not increase or remain at current levels, and we may not be able to successfully market our Mercator product line or develop extensions and enhancements to this product line on a long-term basis. In the event that our current or future competitors release new products that provide, or are perceived as providing, more advanced features, greater functionality, better performance, better compatibility with other systems or lower prices than our Mercator product line, demand for our products and services would likely decline. A decline in demand for, or market acceptance of, our Mercator product line would harm our business.

We may experience difficulties in developing and introducing new or enhanced products necessitated by technological changes.

Our future success will depend, in part, upon our ability to anticipate changes, to enhance our current products and to develop and introduce new products that keep pace with technological advancements and address the increasingly sophisticated needs of our customers. Our products may be rendered obsolete if we fail to anticipate or react to change.

Development of enhancements to existing products and new products depends, in part, on a number of factors, including the following:

- . the timing of releases of new versions of applications systems by vendors;
- . the introduction of new applications, systems or computing platforms;
- . the timing of changes in platforms;
- . the release of new standards or changes to existing standards;
- . changing customer requirements: and
- . the availability of cash to fund development.

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Our product enhancements or new products may not adequately meet the requirements of the marketplace or achieve any significant

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degree of market acceptance. In addition, our introduction or announcement, or those of one or more of our current or future competitors, of products embodying new technologies or features could render our existing products obsolete or unmarketable. Our introduction or announcement of enhanced or new product offerings or by our current or future competitors may cause customers to defer or cancel purchases of our existing products. Any deferment or cancellation of purchases could harm our business.

We could experience delays in developing and releasing new products or product enhancements.

We may experience difficulties that could delay or prevent the successful development, introduction and marketing of new products or product enhancements. We have in the past experienced delays in the introduction of product enhancements and new products and we may experience delays in the future.

Furthermore, as the number of applications, systems and platforms supported by our products increases, we could experience difficulties in developing, on a timely basis, product enhancements which address the increased number of new versions of applications, systems or platforms served by our existing products. If we fail, for technological or other reasons, to develop and introduce product enhancements or new products in a timely and cost-effective manner or if we experience any significant delay in product development or introduction, our customers may delay or decide against purchases of our products, which could harm our business.

The success of our products will also depend upon the success of the platforms we target.

We may, in the future, seek to develop and market enhancements to existing products or new products, which are targeted for applications, systems or platforms that we believe will achieve commercial acceptance. This could require us to devote significant development, sales and marketing personnel, as well as other resources, to these efforts, which would otherwise be available for other purposes. We may not be able to successfully identify these applications, systems or platforms, and even if we do so, they may not achieve commercial acceptance or we may not realize a sufficient return on our investment. Failure of these targeted applications, systems or platforms to achieve commercial acceptance or our failure to achieve a sufficient return on our investment could harm our business.

We may not successfully expand our sales and distribution channels.

An integral part of our strategy is to expand our indirect sales channels, including value-added resellers, independent software vendors, systems integrators and distributors. This channel is accounting for a growing percentage of our total revenues and we are increasing resources dedicated to developing and expanding these indirect distribution channels. We may not be successful in expanding the number of indirect distribution channels for our products. If we are successful in increasing our sales through indirect sales channels, we expect that those sales will be at lower per unit prices than sales through direct channels, and revenue we receive for each sale will be less than if we had licensed the same product to the customer directly.

Selling through indirect channels may also limit our contact with our customers.

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As a result, our ability to accurately forecast sales, evaluate customer satisfaction and recognize emerging customer requirements may be hindered.

Even if we successfully expand our indirect distribution channels, any new value added resellers, independent software vendors, system integrators or distributors may offer competing products, or have no minimum purchase requirements of our products. These third parties may also not have the technical expertise required to market and support our products successfully. If the third parties do not provide adequate levels of services and technical support, our customers could become dissatisfied, and we may have to devote additional resources for customer support. Our brand name and reputation could be harmed. Selling products through indirect sales channels could cause conflicts with the selling efforts of our direct sales force.

Our strategy of marketing products directly to end-users and indirectly through value added resellers; independent software vendors, systems integrators and distributors may result in distribution channel conflicts. Our direct sales efforts may compete with those of our indirect channels and, to the extent different resellers target the same customers, resellers may also come into conflict with each other. Although we have attempted to manage our distribution channels to avoid potential conflicts, channel conflicts may harm our relationships with existing value added resellers, independent software vendors, systems integrators or distributors or impair our ability to attract new value added resellers, independent software vendors, systems integrators and distributors.

We may encounter difficulties in managing our growth.

Our business has grown in recent periods, with total revenues increasing from approximately \$16.1 million in 1995 to \$138.3 million in 2000. We acquired certain assets of Software Consulting Partners in November 1998 and acquired Braid Group Ltd. in March 1999, and Novera Software, Inc. in September 1999. The growth of our business has placed, and is expected to continue to place, a strain on

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our administrative, financial, sales and operational resources and increased demands on our systems and controls.

To address this growth, we have recently implemented, or are in the process of implementing and will implement in the future, a variety of new and upgraded operational and financial systems, procedures and controls. We may not be able to successfully complete the implementation and integration of these systems, procedures and controls, or hire additional personnel, in a timely manner. Our inability to manage our growth and changing business conditions, or to adapt our operational, management and financial control systems to accommodate our growth could harm our business.

We may face significant risks in expanding our international operations.

International revenues accounted for 29% of our total revenues for 1999 compared to 37% of our total revenues for 2000. Continued expansion of our international sales and marketing efforts will require significant management attention and financial resources. We also expect to commit additional time and development resources to customizing our products for selected international markets and to developing international sales and support channels.

International operations involve a number of additional risks, including the following:

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- . impact of possible recessionary environments in economies outside the United States;
- . longer receivables collection periods and greater difficulty in accounts receivable collection;
- . unexpected changes in regulatory requirements;
- . dependence on independent resellers;
- . reduced protection for intellectual property rights in some countries, tariffs and other trade barriers;
- . foreign currency exchange rate fluctuations;
- . difficulties in staffing and managing foreign operations;
- . the burdens of complying with a variety of foreign laws;
- . potentially adverse tax consequences; and
- . political and economic instability.

To the extent that our international operations expand, we expect that an increasing portion of our international license and service and other revenues will be denominated in foreign currencies, subjecting us to fluctuations in foreign currency exchange rates. We do not currently engage in foreign currency hedging transactions. However, as we continue to expand our international operations, exposures to gains and losses on foreign currency transactions may increase. We may choose to limit our exposure by the purchase of forward foreign exchange contracts or similar hedging strategies. The currency exchange strategy that we adopt may not be successful in avoiding exchange-related losses. In addition, the above-listed factors may cause a decline in our future international revenue and, consequently, may harm our business. We may not be able to sustain or increase revenue that we derive from international sources.

Our success depends upon the widespread use and adoption of the internet and intranets.

We believe that demand for enterprise application integration solutions, such as those that we offer, will depend, in part, upon the adoption by businesses and end-users of the internet and intranets as platforms for electronic commerce and communications. The internet and intranets are new and evolving, and they may not be widely adopted, particularly for electronic commerce and communications among businesses. Critical issues concerning the internet and intranets, including security, reliability, cost, ease of use and access and quality of service remain unresolved at this time, inhibiting adoption by many enterprises and end-users. If the internet and intranets are not widely used by businesses and end-users, particularly for electronic commerce, this could harm our business.

Government regulation and legal uncertainties relating to the internet could adversely affect our business.

Congress has recently passed legislation and several more bills have recently been sponsored in both the House and Senate that are designed to regulate certain aspects of the internet, including on-line content, copyright infringement, user privacy, taxation, access

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charges, liability for third-party activities and jurisdiction. In addition, federal, state, local and foreign governmental organizations are also considering other legislative and regulatory proposals that would regulate the internet. Areas of potential regulation include libel, pricing, quality of products and services, and intellectual property ownership.

The laws governing the use of the internet, in general, remain largely unsettled, even in areas where there has been some legislative action. It may take years to determine whether and how existing laws such as those governing intellectual property; privacy, libel and taxation apply to the internet. In addition, the growth and development of the market for online commerce may prompt calls for more stringent consumer protection laws, both in the United States and abroad. This occurrence may impose additional burdens on companies conducting business online by limiting how information can flow over the internet and the type of information that can flow over the internet. The adoption or modification of laws or regulations relating to the internet could adversely affect our business.

It is not known how courts will interpret both existing and new laws. Therefore, we are uncertain as to how new laws or the application of existing laws will affect our business. In addition, our clients who may be subject to such legislation may indirectly affect our business. Increased regulation of the internet may decrease the growth in the use of the internet, which could decrease the demand for our services, increase our cost of doing business or otherwise have a material adverse effect on our business, results of operations and financial condition.

Capacity constraints caused by growth in the use of the internet may, unless resolved, impede further development of the internet to the extent that users experience delays, transmission errors and other difficulties. Further, the adoption of the internet for commerce and communications, particularly by those individuals and companies that have historically relied upon alternative means of commerce and communication generally requires the understanding and acceptance of a new way of conducting business and exchanging information. In particular, companies that have already invested substantial resources in other means of conducting commerce and exchanging information may be particularly reluctant or slow to adopt a new internet-based strategy that may make their existing personnel and infrastructure obsolete. If the necessary infrastructure, products, services or facilities are not developed, or if the internet does not become a viable commercial medium, our business, results of operations and financial condition could be materially and adversely affected.

The United States Omnibus Appropriations Act of 1998 places a moratorium on taxes levied on internet access from October 1, 1998 to October 21, 2001. However, states may place taxes on internet access if taxes had already been generally imposed and actually enforced prior to October 1, 1998. States which can show they enforced internet access taxes prior to October 1, 1998 and states after October 21, 2001 may be able to levy taxes on internet access resulting in increased cost to access to the internet, resulting in a material adverse effect on our business.

We face significant competition in the market for e-business integration software.

The market for our products and services is extremely competitive and subject to rapid change. Because there are relatively low barriers to entry in the software market, we expect additional competition from other established and emerging companies.

In the e-business integration market, our Mercator products and related services compete primarily against solutions developed internally by individual businesses to meet their specific e-business integration needs. In addition, we

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face increasing competition in the e-business integration market from other third-party software vendors.

Many of our current and potential competitors have longer operating histories, significantly greater financial, technical, product development and marketing resources, greater name recognition and larger customer bases than we do. Our present or future competitors may be able to develop products that are comparable or superior to those we offer, adapt more quickly than we do to new technologies, evolving industry trends or customer requirements, or devote greater resources than we do to the development, promotion and sale of their products. Accordingly, we may not be able to compete effectively in our target markets against these competitors.

We expect that we will face increasing pricing pressures from our current competitors and new market entrants. Our competitors may engage in pricing practices that reduce the average selling prices of our products and related services. To offset declining average selling prices, we believe that we must successfully introduce and sell enhancements to existing products and new products on a timely basis. We must also develop enhancements to existing products and new products that incorporate features that can be sold at higher average selling prices. To the extent that enhancements to existing products and new products are not developed in a timely manner, do not achieve customer acceptance or do not generate higher average selling prices, our operating margins may decline.

We have only limited protection for our proprietary technology.

Our success is dependent upon our proprietary software technology. We do not currently have any patents and we rely principally on

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trade secret, copyright and trademark laws, nondisclosure and other contractual agreements and technical measures to protect our technology. We also believe that factors such as the technological and creative skills of our personnel, product enhancements and new product developments are essential to establishing and maintaining a technology leadership position. We enter into confidentiality and/or license agreements with our employees, distributors and customers, and we limit access to and distribution of our software, documentation and other proprietary information. The steps taken by us may not be sufficient to prevent misappropriation of our technology, and such protections do not preclude competitors from developing products with functionality or features similar to our products. Furthermore, it is possible that third parties will independently develop competing technologies that are substantially equivalent or superior to our technologies. In addition, effective copyright and trade secret protection may be unavailable or limited in certain foreign countries, which could pose additional risks of infringement as we continues to expand internationally. Our failure or inability to protect our proprietary technology could have a material adverse effect on our business.

Although we do not believe our products infringe the proprietary rights of any third parties, infringement claims could be asserted against us or our customers in the future. Furthermore, we may initiate claims or litigation against third parties for infringement of our proprietary rights, or for purposes of establishing the validity of our proprietary rights. Litigation, either as plaintiff or defendant, would cause us to incur substantial costs and divert management resources from productive tasks whether or not such litigation is resolved in our favor, which could have a material adverse effect on our business. Parties making claims against us could secure substantial damages, as well as injunctive or other equitable relief, which could effectively block our ability to license our products in the United States or abroad. Such a judgment

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could have a material adverse effect on our business. If it appears necessary or desirable, we may seek licenses to intellectual property that it is allegedly infringing. Licenses may not be obtainable on commercially reasonable terms, if at all. The failure to obtain necessary licenses or other rights could have a material adverse effect on our business. As the number of software products in the industry increases and the functionality of these products further overlaps, we believe that software developers may become increasingly subject to infringement claims. Any such claims, with or without merit, can be time-consuming and expensive to defend and could adversely affect our business. We are not aware of any currently pending claims that our products, trademarks or other proprietary rights infringe upon the proprietary rights of third parties.

We may become subject to infringement claims.

Although we do not believe that our products infringe the proprietary rights of any third parties, third parties might assert infringement claims against us or our customers in the future. Furthermore, we may initiate claims or litigation against third parties for infringement of our proprietary rights or to establish the validity of our proprietary rights. Litigation, either as plaintiff or defendant, would cause us to incur substantial costs and divert management resources from productive tasks. Any litigation, regardless of the outcome, could harm our business. Furthermore, parties making claims against us could secure substantial damages, as well as injunctive or other equitable relief, which could effectively block our ability to license our products in the United States or abroad. A large monetary judgment could harm our business.

Securities Litigation

As is outlined below in Part II, Item 1, after the restatement of our first quarter 2000 earnings and the adjustment to previously disclosed second quarter 2000 results, the Company was named in a series of similar purported securities class action lawsuits. These lawsuits have now been consolidated into one matter. The amended complaint in the consolidated matter alleges violations of United States federal securities law through alleged material misrepresentations and omissions and seeks an unspecified award of damages. We believe that the allegations in the amended complaint are without merit and we intend to contest them vigorously. However, there can be no guarantee as to the ultimate outcome as to this pending litigation matter.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In the ordinary course of operations, our financial position and cash flows are subject to a variety of risks, which include market risks associated with changes in foreign currency exchange rates and movement in interest rates. We do not, in the normal course of business, use derivative financial instruments for trading or speculative purposes. Uncertainties that are either non-financial or non-quantifiable, such as political, economic, tax, other regulatory or credit risks are not included in the following assessment of our market risks.

Foreign Currency Exchange Rates

Operations outside of the U.S. expose us to foreign currency exchange rate changes and could impact translations of foreign denominated assets and liabilities into U.S. dollars and future earnings and cash flows from transactions denominated in different currencies. During the quarter ended March 31, 2001, 43% of our total revenue was generated from our international operations, and the net assets of our foreign subsidiaries totaled approximately 70% of consolidated net assets as of March 31, 2001. Our exposure to currency exchange rate changes is diversified due to the number of different countries in which we conduct business. We operate

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outside the U.S. primarily through wholly owned subsidiaries in the United Kingdom, France, Germany, Singapore, Hong Kong, and Australia. These foreign subsidiaries use local currencies as their functional currency, as sales are generated and expenses are incurred in such currencies. Foreign currency gains and losses will continue to result from fluctuations in the value of the currencies in which we conduct our operations as compared to the U.S. dollar. We do not believe that possible near-term changes in exchange rates will result in a material effect on our future earnings or cash flows and, therefore, have chosen not to enter into foreign currency hedging instruments. There can be no assurance that this approach will be successful, especially in the event of a sudden and significant decline in the value of foreign currencies relative to the United States dollar.

Interest Rates

We invest our cash in a variety of financial instruments, consisting principally of investments in commercial paper, interest-bearing demand deposit accounts with financial institutions, money market funds and highly liquid debt securities of corporations, municipalities and the U.S. Government. These investments are denominated in U.S. dollars. Cash balances in foreign currencies overseas are operating balances and are only invested in short-term deposits of the local operating bank.

We classify our investment instruments as available-for-sale in accordance with Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities", (SFAS No. 115). Investments in both fixed rate and floating rate interest earning instruments carry a degree of interest rate risk. Changes in interest rates could impact our anticipated interest income or could impact the fair market value of our investments. However, we believe these changes in interest rates will not cause a material impact on our financial position, results of operations or cash flows.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On or about February 1, 2000, Mercator was named as a defendant and served with a complaint in an action entitled Carpet Co-Op of America Association, Inc., and FloorLINK, L.L.C. v. TSI International Software, Ltd., Civil Action No. 00CC-0231, pending in the Circuit Court of St. Louis County, Missouri (the "Missouri Action"). The complaint includes counts for breach of contract, fraud and negligent misrepresentation in connection with certain software implementation work provided under contract by Mercator. The plaintiffs allege that Mercator failed to provide and implement certain software products and designs within an alleged time requirement and misrepresented Mercator's ability to implement the products within that timeframe. The complaint seeks an unspecified damage amount in excess of \$2 million. On or about March 30, 2000, plaintiffs in the Missouri Action filed an amended complaint adding a claim of negligence in connection with the contract. On April 10, 2000, Mercator filed a motion to dismiss the Missouri Action in its entirety, which currently is pending. On March 30, 2001 the Missouri Court heard oral argument on the motion. Mercator believes that the allegations in the amended complaint in the Missouri Action are without merit and intends to contest them vigorously.

On March 30, 2000, Mercator filed an action entitled TSI International Software, Ltd. (d/b/a Mercator Software Inc.) v. Carpet Co-op of America Association, Inc. and FloorLink, LLC, Civil Action No. 300-CV-603 (SRU), in the United States District Court for the District of Connecticut (the "Connecticut Action"). The Connecticut Action asserts claims for copyright infringement, trademark

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infringement, unfair competition, misappropriation of trade secrets, breach of contract, fraud, unjust enrichment and violation of the Connecticut Unfair Trade Practices Act, in connection with the software implementation project at issue in the Missouri Action. The Mercator complaint in the Connecticut Action alleges that the defendants have failed to pay the more than \$1.7 million still owed to Mercator under the contract, and that, during the course of the project, the defendants fraudulently misappropriated certain of Mercator's copyrighted software, trademarks and other software implementation related secrets. On May 9, 2000, the court in the Connecticut Action entered a Stipulated Injunction barring the defendants from using, copying or disclosing any of Mercator's copyrighted software, trademarks or other trade secrets or proprietary information. On May 12, 2000, the defendants filed a motion to dismiss the Connecticut Action. On December 15, 2000, the court in the Connecticut Action denied the defendants' motion to dismiss insofar as it related to Mercator's federal claims and, on March 21, 2001, the Connecticut Court denied the motion to dismiss as to the state law claims. On April 4, 2001, defendants filed an answer to Mercator's complaint along with counterclaims asserting substantially the same claims as those asserted in the Missouri Action. On May 1, 2001, Mercator filed a motion to dismiss defendants' counterclaims for fraud, negligent misrepresentation, and negligence and to strike defendants' prayers for consequential and punitive damages. The Connecticut Court has not yet ruled on Mercator's motion and no hearing has been set. Mercator believes that the allegations in defendants' counterclaims are without merit and intends to contest them vigorously.

Between August 23, 2000 and September 21, 2000 a series of fourteen purported securities class action lawsuits were filed in the United States District Court for the District of Connecticut, naming as defendants Mercator, Constance Galley and Ira Gerard. Kevin

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McKay was also named as a defendant in nine of these complaints. On or about November 24, 2000, these lawsuits were consolidated into one lawsuit captioned: In re Mercator Software, Inc. Securities Litigation, Master File No. 3:00-CV-1610 (GLG). The lead plaintiffs purport to represent a class of all persons who purchased Mercator's common stock from April 20, 2000 through and including August 21, 2000. Each complaint in the new consolidated action alleges violations of Section 10(b) and Rule 10b-5 through alleged material misrepresentations and omissions and seeks an unspecified award of damages. On January 26, 2001 the lead plaintiffs filed an amended complaint in the consolidated matter with substantially the same allegations. Named as defendants in the amended complaint are Mercator, Constance Galley and Ira Gerard. The amended complaint in the consolidated action alleges violations of Section 10(b) and Rule 10b-5 through alleged material misrepresentations and omissions and seeks an unspecified award of damages. Mercator filed a motion to dismiss the amended complaint on March 12, 2001. The lead plaintiffs filed an opposition to Mercator's motion to dismiss on or about April 18, 2001, and Mercator filed its reply brief on May 7, 2001. Mercator believes that the allegations in the amended complaint are without merit and intends to contest them vigorously.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

In January 2001 the Company issued for fair market value 228,180 shares of its common stock, \$.01 par value, to Mitsui & Co., Ltd. for \$2.0 million in cash. For this sale the Company relied upon Section 4(2) of the Securities Act of 1933. These proceeds were used for general corporate purposes.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

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a. List of Exhibits

| Exhibit | Description of Exhibit |
|---------|---|
| 10.1 | Employment Agreement dated as of January 16, 2001 between Registrant and Roy C. King/(1)/ |
| 10.2 | Lease Agreement dated as of January 29, 2001 between Registrant and CDR Federal LLC/(1)/ |

(1) Previously filed as an exhibit to Mercator Software's current Annual Report on Form 10-K filed on March 30, 2001 and incorporated herein by reference.

b. Reports on Form 8-K

No reports on Form 8-K have been filed during the quarter for which this report is filed.

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SIGNATURES

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

MERCATOR SOFTWARE, INC.

Dated: May 15, 2001

By /s/ Roy C. King

Roy C. King

President, Chief Executive Officer and
Chairman of the Board of Directors

Dated: May 15, 2001

By /s/ Richard M. Applegate

Richard M. Applegate

Senior Vice President, Chief Financial
Officer and Treasurer

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Exhibit Index

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