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

FORM 10-Q

[Mark One]

☒ **QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2004.

OR

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

For the transition period from ______ to ______.

Commission File No. 000-31003

CORIO, INC.
(Exact name of the Registrant as specified in its charter)

Delaware **(state or other jurisdiction of Incorporation or organization)**	**77-200492528** **(I.R.S. Employer Identification Number)**
959 Skyway Road, Suite 100 **San Carlos, California** **(Address of principal executive offices)**	**94070** **(Zip Code)**

650-232-3000
(The Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒

As of November 8, 2004, there were 64,408,526 shares of the Registrant's common stock outstanding.

CORIO, INC.
QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2004

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PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

CORIO, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)
(UNAUDITED)

	September 30, 2004	December 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,431	$ 15,440
Short-term investments	20,843	19,591
Accounts receivable, net of allowance of $654 and $591 at September 30, 2004 and December 31, 2003, respectively	8,517	6,484
Prepaid expenses and other current assets	1,688	2,502
Total current assets	38,479	44,017
Restricted cash	7,853	7,680
Property and equipment, net	14,105	10,907
Other assets	8,574	9,539
Total assets	$ 69,011	$ 72,143
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 7,080	$ 6,759
Accrued liabilities	6,577	7,216
Accrued restructuring	718	701
Deferred revenue	3,049	4,017
Current portion of bank term commitment payable	7,000	--
Current portion of capital lease obligations	301	476
Total current liabilities	24,725	19,169
Capital lease obligations less current portion	174	387
Accrued restructuring less current portion	3,520	4,068
Other liabilities	1,406	1,283
Total liabilities	29,825	24,907
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock: $0.001 par value; 10,000,000 shares authorized, none issued and outstanding	--	--
Common stock: $0.001 par value; 200,000,000 shares authorized; 63,883,437 and 61,767,102 shares issued and outstanding at September 30, 2004 and December 31, 2003, respectively	63	61
Additional paid-in capital	309,097	306,735
Accumulated other comprehensive income (loss)	(39)	12
Deferred stock-based compensation	--	(3)
Accumulated deficit	(269,935)	(259,569)
Total stockholders' equity	39,186	47,236
Total liabilities and stockholders' equity	$ 69,011	$ 72,143

See accompanying notes to condensed consolidated financial statements.

CORIO, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)
(UNAUDITED)

	Three Months Ended September 30, 2004	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
REVENUES:				
Application management services	$ 14,379	$ 14,295	$ 43,069	$ 45,762
Professional services and other	3,445	1,245	10,025	5,833
Total revenues	17,824	15,540	53,094	51,595
COSTS AND EXPENSES:				
Application management services *	11,800	11,210	34,692	36,333
Professional services and other	2,855	730	8,568	4,455
Research and development *	562	1,123	1,747	3,819
Sales and marketing *	2,417	2,125	7,848	6,632
General and administrative *	3,274	2,339	8,508	6,917
Restructuring charges	714	--	714	2,334
Amortization of stock-based compensation	--	(34)	3	445
Amortization of intangible assets	273	367	1,191	1,257
Total operating expenses	21,895	17,860	63,271	62,192
Loss from operations	(4,071)	(2,320)	(10,177)	(10,597)
Interest and other income	161	136	384	518
Interest and other expense	(394)	(73)	(458)	(285)
Net loss before income tax expense	(4,304)	(2,257)	(10,251)	(10,364)
Income tax expense	--	--	(115)	--
Net loss	$ (4,304)	$ (2,257)	$ (10,366)	$ (10,364)
Basic and diluted net loss per share	$ (0.07)	$ (0.04)	$ (0.16)	$ (0.18)
Shares used in computation-basic and diluted	63,515	57,684	63,124	56,098
* Amortization (reversal) of stock-based compensation not included in expense line item:				
Application management services	$ --	$ 7	$ --	$ 65
Research and development	--	11	1	2
Sales and marketing	--	27	1	187
General and administrative	--	(79)	1	191
Total amortization of stock-based compensation	$ --	$ (34)	$ 3	$ 445

See accompanying notes to condensed consolidated financial statements.

CORIO, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
(UNAUDITED)

	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (10,366)	$ (10,364)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation	6,011	8,788
Amortization of intangible assets	1,191	1,257
Amortization of stock-based compensation	3	445
Amortization of warrants	10	426
Amortization of investments	199	515
Compensation for grants of stock, options and warrants in exchange for services	--	22
Gain on sale and disposal of property and equipment	(61)	--
Loss on sale and disposal of property and equipment	1,059	--
Changes in assets and liabilities:		
Accounts receivable, net	(2,033)	2,735
Prepaid expenses and other current assets	814	978
Accounts payable	321	(3,345)
Accrued liabilities	(1,213)	(3,674)
Deferred revenue	(968)	(546)
Other liabilities	165	1,893
Net cash used in operating activities	(4,868)	(870)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of short-term investments	(21,697)	(37,318)
Sales of short-term investments	20,195	29,626
Increase in restricted cash	(173)	--
Purchase of property and equipment	(10,268)	(3,183)
Proceeds from sale of property and equipment	61	--
Other assets	(235)	266
Cash paid for acquisition	--	(361)
Net cash used in investing activities	(12,117)	(10,970)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from sale of common stock and exercise of stock options	2,364	1,058
Borrowings (repayments) on debt obligations	7,000	(272)
Payments on capital lease obligations	(388)	(4,269)
Net cash provided by (used in) financing activities	8,976	(3,483)
Net decrease in cash and cash equivalents	(8,009)	(15,323)
Cash and cash equivalents, beginning of period	15,440	26,908
Cash and cash equivalents, end of period	$ 7,431	$ 11,585
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest and taxes	$ (211)	$ 268
SUPPLEMENTAL NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Deferred stock-based compensation/forfeitures, net	$ --	$ 389
Net unrealized gain (loss) on investments	$ (55)	$ (80)

See accompanying notes to condensed consolidated financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared by Corio, Inc. ("Corio" or the "Company") and reflect all adjustments that are, in the opinion of management, necessary for a fair presentation of the interim periods presented. Such adjustments are of a normal recurring nature. The results of operations for the interim periods presented are not necessarily indicative of the results for any future interim period or for the entire fiscal year. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been omitted, although the Company believes that the disclosures included are adequate to make the information presented not misleading. The unaudited condensed consolidated financial statements and notes included herein should be read in conjunction with the audited consolidated financial statements and accompanying notes included in the Company's Annual Report on Form 10-K/A for the year ended December 31, 2003.

PRINCIPLES OF CONSOLIDATION

The condensed consolidated financial statements include the accounts of Corio and its wholly owned subsidiary. All intercompany accounts and transactions have been eliminated.

NET LOSS PER SHARE

Basic net loss per share is computed by dividing the net loss for the period by the weighted average number of shares of common stock outstanding during the period (excluding shares subject to repurchase). Diluted net loss per share is computed by dividing the net loss for the period by the weighted-average number of shares of common stock and potentially dilutive common securities outstanding during the period. Potentially dilutive shares of common stock are excluded from the diluted net loss per share computation in loss periods, as their effect would be antidilutive.

The following table sets forth potentially dilutive shares of common stock that are not included in the diluted net loss per share calculation as their effect would have been antidilutive for the periods indicated (in thousands, except weighted-average exercise price).

	Nine Months Ended September 30,			
	2004		2003	
	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares
Common stock subject to repurchase..........	$ --	--	$ 0.01	200
Common stock options and warrants..........	$ 1.97	18,420	$ 1.85	17,779

STOCK-BASED COMPENSATION

The Company accounts for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees* and related interpretations and complies with the disclosure provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, *Accounting for Stock-Based Compensation,* as amended by SFAS 148, *Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123.* Under APB No. 25, compensation expense is based on the difference, if any, on the date of the grant between the fair value of the Company's stock and the exercise price of the underlying option. Deferred compensation is amortized and expensed in accordance with the graded vesting approach provided for in Financial Accounting Standards Board ("FASB") Interpretation No. 28.

The Company accounts for stock issued to non-employees in accordance with the provisions of SFAS No. 123 and FASB Emerging Issues Task Force Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. The Company uses the Black-Scholes option-pricing model to value options granted to non-employees. The expense is recorded over the period in which the related services are received.

If compensation cost for the Company's stock-based compensation plans had been determined based on fair value at the grant dates for the awards under a method prescribed by SFAS No. 123, the Company's net loss would have increased to the pro forma amounts indicated below (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net loss as reported	$ (4,304)	$ (2,257)	$ (10,366)	$ (10,364)
Add stock-based employee compensation expense included in reported net loss, net of tax of $0	--	(34)	3	445
Deduct total stock-based employee compensation determined under the fair-value-based method for all awards, net of tax of $0	(1,170)	(1,093)	(3,670)	(4,502)
Pro forma net loss	$ (5,474)	$ (3,384)	$ (14,033)	$ (14,421)
Basic and diluted net loss per share:				
As reported	$ (0.07)	$ (0.04)	$ (0.16)	$ (0.18)
Pro forma	$ (0.09)	$ (0.06)	$ (0.22)	$ (0.26)

The Company calculated the fair value of each option granted under the Company's stock option plans on the date of grant using the Black-Scholes option pricing model and calculated amortization using the graded vesting approach with the following weighted-average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Expected life (in years)	4.0	4.0	4.0	4.0
Risk free interest rate	3.30%	2.99%	2.97%	2.47%
Volatility	109%	102%	111%	105%
Dividend yield	0%	0%	0%	0%

Weighted-average fair values per share for options granted under the Company's stock option plans during the three and nine months ended September 30, 2004 and 2003 were:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Weighted-average fair value per share for options granted under the Company's stock option plans	$ 1.08	$ 1.99	$ 1.70	$ 0.80

The Company calculated the fair value of each option granted under the Company's employee stock purchase plan on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Expected life (in years)	0.5	0.5	0.5	0.5
Risk free interest rate	1.65%	1.00%	1.33%	1.06%
Volatility	79%	102%	81%	104%
Dividend yield	0%	0%	0%	0%

Weighted-average fair values per share for options granted under the Company's employee stock purchase plan during the three and nine months ended September 30, 2004 and 2003 were:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Weighted-average fair value per share for options granted under the Company's employee stock purchase plan	$ 0.61	$ 0.83	0.83	$ 0.45

There were no common stock purchase rights granted under the Company's employee stock purchase plan during the three months ended September 30, 2004 and 2003.

RESTRICTED CASH

In connection with two facility leases, the Company issued letters of credit to the facility lessors as security for the leases. The letters of credit may initially be drawn upon for a period of one year and each letter provides for automatic one-year renewal periods. The letters of credit are collateralized by a $7.9 million cash deposit, which is recorded as restricted cash on the accompanying condensed consolidated balance sheet. For the three and nine month periods ended September 30, 2004, the amount of restricted cash increased by $0 and $173,000, respectively. The amount of restricted cash the Company recorded increased by $173,000 in March 2004 due to the required additional collateral requirements related to a standby letter of credit we issued in connection with a move to our new leased operations office in Phoenix, Arizona.

RECLASSIFICATION

Certain reclassifications have been made to prior period amounts to be consistent with current period presentation in the condensed consolidated statements of cash flows.

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2003, the SEC issued Staff Accounting Bulletin ("SAB") No. 104, *Revenue Recognition*, which supersedes SAB No. 101, *Revenue Recognition in Financial Statements.* SAB No. 104 rescinds accounting guidance in SAB No. 101 related to multiple-element arrangements as this guidance has been superseded as a result of the issuance of EITF 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*. The adoption of SAB No. 104 did not have a material effect on our financial position or results of operations.

In March 2004, the EITF reached consensus on Issue 03-01 ("EITF 03-01"), *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. EITF 03-01 includes new guidance for evaluating and recording impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are deemed to be temporarily impaired. The accounting guidance of EITF 03-01 is effective for reporting periods beginning after June 15, 2004, while the disclosure requirements for debt and equity securities accounted for under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* are effective for annual periods ending after December 15, 2003. The Company does not believe that the adoption of EITF 03-01 will have a material effect on its financial position or results of operations.

NOTE 2—ACCOUNTS RECEIVABLE

The Company records accounts receivable when amounts are invoiced in accordance with the contract terms or as services are performed under non-cancelable contractual services arrangements. At September 30, 2004 and December 31, 2003, the Company's accounts receivable balance excluded outstanding invoices of $1,732,000 and $1,444,000, respectively, related to customers that the Company determined to be cash basis customers due to credit risks associated with these customers. Since the revenue related to the collection of these invoices is recognized on a cash basis, these amounts have not been included in the accounts receivable or deferred revenue balances.

Included in accounts receivable at September 30, 2004 and December 31, 2003 were $848,000 and $332,000, respectively, of unbilled receivables under various application management and professional services contracts.

NOTE 3—WARRANTS

On September 27, 2000, Cap Gemini Ernst & Young U.S., L.L.C exercised its right to convert a portion of its initial warrant representing 2,333,333 shares into 960,810 shares of common stock through a cashless exercise. Because the exercised shares outstanding were repurchaseable under certain circumstances, the fair value of the shares was remeasured each reporting period from exercise until May 2003, when the Company's repurchase right lapsed. With respect to these shares, the Company did not record an amortization expense in sales and marketing for the three months ended September 30, 2004 and 2003, respectively. Amortization of expense for the nine months ended September 30, 2004 and 2003 was $0 and $416,000, respectively. There will be no further amortization expense related to these warrants.

NOTE 4—STOCK-BASED COMPENSATION

In connection with stock options granted to employees to purchase common stock, the Company recorded reductions in deferred stock-based compensation of $0 and $116,000 for the three months ended September 30, 2004 and 2003, respectively, and $0 and $389,000 for the nine months ended September 30, 2004 and 2003, respectively. Such amounts represent unamortized deferred stock compensation for unvested options that were forfeited upon severance. The deferred charges for employee options are being amortized to expense using the graded vesting approach, prescribed by FASB Interpretation No. 28, through 2004. Amortization of deferred stock-based compensation expense (credit) was $0 and ($34,000) for the three months ended September 30, 2004 and 2003, respectively and $3,000 and $445,000 for the nine months ended September 30, 2004 and 2003, respectively, net of stock options forfeited.

NOTE 5—SIGNIFICANT CUSTOMER INFORMATION AND SEGMENT REPORTING INFORMATION

The Company's operations have been classified into two reportable segments (i) application management services and (ii) professional services. Corporate expenses, including those for sales and marketing, general and administrative and research and development, are not allocated to reportable segments.

Disaggregated information is as follows (in thousands):

	Application Management Services	Professional Services	Unallocated	Total
For the Three Months Ended September 30, 2004				
Revenues	$ 14,379	$ 3,445	$ --	$ 17,824
Depreciation	$ 1,801	$ 1	$ 213	$ 2,015
Amortization of warrants	$ --	$ --	$ 3	$ 3
Amortization of intangible assets	$ 234	$ 39	$ --	$ 273
Segment profit (loss) from operations	$ 1,912	$ 548	$ (6,531)	$ (4,071)
For the Three Months Ended September 30, 2003				
Revenues	$ 14,295	$ 1,245	$ --	$ 15,540
Depreciation	$ 2,436	$ 2	$ 263	$ 2,701
Amortization of stock-based compensation	$ 7	$ --	$ (41)	$ (34)
Amortization of warrants	$ --	$ --	$ 3	$ 3
Amortization of intangible assets	$ 367	$ --	$ --	$ 367
Segment profit (loss) from operations	$ 2,711	$ 515	$ (5,546)	$ (2,320)
For the Nine Months Ended September 30, 2004				
Revenues	$ 43,069	$ 10,025	$ --	$ 53,094
Depreciation	$ 5,369	$ 2	$ 640	$ 6,011
Amortization of stock-based compensation	$ --	$ --	$ 3	$ 3
Amortization of warrants	$ --	$ --	$ 9	$ 9
Amortization of intangible assets	$ 990	$ 200	$ --	$ 1,190
Segment profit (loss) from operations	$ 6,953	$ 1,253	$ (18,383)	$ (10,177)
For the Nine Months Ended September 30, 2003				
Revenues	$ 45,762	$ 5,833	$ --	$ 51,595
Depreciation	$ 7,625	$ 14	$ 1,149	$ 8,788
Amortization of stock-based compensation	$ 65	$ --	$ 380	$ 445
Amortization of warrants	$ --	$ --	$ 427	$ 427
Amortization of intangible assets	$ 1,257	$ --	$ --	$ 1,257
Segment profit (loss) from operations	$ 8,107	$ 1,378	$ (20,082)	$ (10,597)

The Company does not allocate all assets to its reportable segments, nor does it allocate interest income or interest expense.

Significant customer information is as follows:

	PERCENTAGE OF TOTAL REVENUE				ACCOUNTS RECEIVABLE	
	Three Months Ended September 30,		Nine Months Ended September 30,		September 30,	December 31,
	2004	2003	2004	2003	2004	2003
Customer A	11%	17%	11%	12%	--	--
Customer B	--	--	--	--	--	34%

Percentages are listed in the table above only when the result is 10% or greater. Customer A is a cash basis customer and therefore its outstanding invoices have not been included in the Company's accounts receivable balances. Customer A terminated its customer contract effective July 29, 2004.

NOTE 6—RESTRUCTURING AND IMPAIRMENT ACCRUAL

The following table (in thousands) sets forth the charges taken against the restructuring and impairment accrual in the nine-month period ended September 30, 2004 and the three-month period ended September 30, 2004.

	December 31, 2003	Year to Date Cash Payments	September 30, 2004
Office lease obligations..........	$ 4,769	$ (532)	$ 4,237

	June 30, 2004	Quarterly Cash Payments	September 30, 2004
Office lease obligations..........	$ 4,414	$ (177)	$ 4,237

In May 2003, the Company signed an agreement to sublease the vacated portion of its headquarters facility through the end of its lease, which is March 2010. In the first quarter of 2003, the Company adjusted its estimated loss related to the vacated space and recorded an additional restructuring charge of $2.5 million to reflect the terms of the sublease agreement. The impact of this charge was partially offset by the favorable resolution of a liability related to various leases, which resulted in a reduction of $139,000 to the previously established restructuring reserve.

NOTE 7—INCOME TAXES

Since inception, the Company has incurred net losses for federal and state income tax purposes and anticipates losses for the foreseeable future. The Company did not record any tax expense for the three months ended September 30, 2004 and 2003, respectively. Tax expense was $115,000 and $0 for the nine months ended September 30, 2004 and 2003, respectively. The tax expense is primarily for state and local purposes, which is determined based on gross receipts or capital.

NOTE 8—COMMITMENTS AND CONTINGENCIES

Equipment and Software Financing Agreement

On March 17, 2004, the Company entered into a $7 million term commitment payable with Wells Fargo Bank. The proceeds from this financing have been used to finance the purchase of new equipment and software. In connection with the term commitment payable the Company issued a promissory note dated March 17, 2004 for a loan up to $7 million. Under the term commitment payable the Company could draw against the note through September 2004. Outstanding balances under the note will accrue interest at a rate of LIBOR plus 1.75%, however, the interest rate can be changed, at the option of the Company, to a floating rate of prime minus 0.25%. Additionally, the Company is obligated to pay interest on outstanding balances until October 1, 2004, at which time, the term commitment payable converts into a term loan with principal and interest payments due monthly. The outstanding principal balance under the term loan and interest payments will be payable over 30 months. The term loan interest rate can either be LIBOR or fixed. Principal is due in full February 2007. As of September 30, 2004, the outstanding balance was $7.0 million and the interest rate was 4.5%. This agreement contains various financial covenants regarding liquidity, net worth and results from operations.

Covenants associated with this loan require that the Company's results from operations generate certain levels of EBITDA (earnings before interest, taxes, depreciation and amortization) on a quarterly basis. The Company did not meet the EBITDA covenant for the quarters ended June 30, 2004 and September 30, 2004 and obtained waivers from Wells Fargo Bank related to each covenant violation. The Company has classified this obligation as current as the Company has future quarterly EBITDA covenants that it does not believe it will be able to comply with due to increased operating expenses and the loss of revenue associated with the customer contract with Expanets/Avaya, Inc., which terminated on July 29, 2004. The Company is in discussions with Wells Fargo Bank regarding how to address anticipated future EBITDA covenant violations. We have $28.3 million of unrestricted cash, cash equivalents and short-term investments as of September 30, 2004.

Service Level Agreements

The Company's application management services contracts contain service level agreements that obligate the Company to provide software applications management services at certain levels of performance. Numerous factors can affect the service level provided by the Company. If the Company fails to meet the committed service levels, the Company may be contractually obligated to provide a partial credit for the services rendered. If the Company were to continue to fail to meet these service levels, certain customers may then have the right to cancel their contracts with the Company. The Company's contracts generally limit the circumstances in which the Company would provide credits to its customers. The Company believes its policies and practices limit its exposure relating to these service level obligations, however, the Company cannot determine the maximum amount of future credits, if any, related to such service level obligations. The Company's services contracts have standard indemnification provisions.

Lease Guarantees

In connection with a San Carlos facility lease, the Company issued a $7 million letter of credit for the lease. As of September 30, 2004, a $7 million cash deposit is held as collateral by a financial institution for guarantee of the letter of credit. The cash deposit is recorded as restricted cash on the balance sheet.

In connection with a Phoenix facility lease, the Company issued an $853,430 letter of credit as security for the lease. As of September 30, 2004, an $853,430 cash deposit is held as collateral by a financial institution for guarantee of the letter of credit. The cash deposit is recorded as restricted cash on the balance sheet.

Legal Proceedings

In November 2001, a securities class action lawsuit was filed in the U.S. District Court for the Southern District of New York against Corio, certain of its officers and certain of the underwriters involved in Corio's initial public offering. This is one of approximately 300 similar lawsuits in a coordinated proceeding sometimes referred to as "IPO allocation lawsuits" or "laddering lawsuits." The plaintiffs generally allege that the underwriters engaged in undisclosed improper practices by giving favorable allocations of IPO shares to certain investors in exchange for excessive brokerage commissions and/or agreements for those investors to purchase additional shares in the aftermarket at predetermined higher prices. The plaintiffs seek an unspecified amount of damages. In June 2003, the plaintiffs in these cases presented a settlement proposal to all of the issuer defendants. Under the proposed settlement, the plaintiffs proposed to dismiss and release all claims against participating defendants in exchange for a contingent payment guaranty by the insurance companies collectively responsible for insuring the issuers in all the related cases, and the assignment or surrender to the plaintiffs of certain claims the issuer defendants may have against the underwriters. Under the guaranty, the insurers or companies will be required to pay the amount, if any, by which $1 billion exceeds the aggregate amount ultimately collected by the plaintiffs from the underwriter defendants in all the cases. If the plaintiffs fail to recover $1 billion and payment is required under the guaranty, Corio would be responsible to pay its pro rata portion of the shortfall, up to the amount of the self-insured retention under its insurance policy, which is $1 million. In July 2003, Corio tentatively agreed to accept this settlement proposal. The settlement is subject to acceptance by a substantial majority of the issuer defendants and execution of a definitive settlement agreement. The settlement is also subject to approval by the Court, which cannot be assured, and the underwriters recently objected to the settlement. If the settlement is not accepted by the requisite number of defendants or if it is not approved by the Court or if it otherwise is not consummated, Corio intends to defend the lawsuit vigorously. However, the litigation is in the preliminary stage, and we cannot predict its outcome. The litigation process is inherently uncertain. If the outcome of the litigation were adverse to us and if we are required to pay significant monetary damages, our business would be significantly harmed. This lawsuit may be time consuming and expensive to defend and may divert management's attention and may be costly to Corio even if the plaintiff's settlement proposal is consummated. As of September 30, 2004, no amount is accrued, as management does not believe that a loss is probable.

In November 2001, Corio filed a demand for arbitration against LivePerson, Inc. with the American Arbitration Association in San Francisco County. The arbitration related to a dispute around a services contract between the parties. On July 23, 2003, the arbitrator in this dispute issued a judgment awarding Corio damages of $1,115,440 plus interest. LivePerson, Inc. filed a motion to vacate the award in the Superior Court of California. On November 18, 2003, the Superior Court of California issued a judgment, relating to the arbitration, awarding Corio damages of $1,346,605 plus interest from October 17, 2003 until the date of payment. LivePerson, Inc. paid Corio $1,369,479 on December 18, 2003 and subsequently appealed the judgment. On October 8, 2004, the Appellate Court of California affirmed the judgment of the Superior Court of California in favor of Corio. For any portion of the cash paid that is determined by the Company as revenue that should be recorded under the Company's revenue recognition policy, such cash received pursuant to this award will be recorded as termination fee revenue at that time. The Company recorded the cash received as an accrued liability.

The Company is subject to other legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, management does not expect that the ultimate costs to resolve these other matters will have a material adverse effect on the Company's financial statements.

Contingent Earn-out Payment

On October 22, 2003, the Company completed the purchase of the assets and the assumption of certain liabilities of Nexus. The Company paid Nexus approximately $10.2 million, consisting of $1.9 million in cash and 2,921,390 shares of Corio common stock, including $177,000 related to legal expenses. In addition, Nexus is entitled to receive an earn-out payment of up to $2.0 million payable in shares of Corio common stock contingent upon specified revenue milestones for the three-month period ending December 31, 2004 from identified existing and prospective customers of Nexus. In accordance with the terms of the asset purchase agreement, $500,000 of the purchase price was also deposited into an escrow account, all of which has been distributed.

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

The following Management's Discussion and Analysis of our Financial Condition and Results of Operations should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto included in Part I-Item 1 of this Quarterly Report and the audited financial statements and notes thereto and Management's Discussion and Analysis in our 2003 Annual Report on Form 10K/A.

Notes Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q includes statements that reflect our belief concerning future events and financial performance. Statements which are not purely historical in nature are called "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. We sometimes identify forward-looking statements with such words as "may", "will", "should", "expect", "anticipate", "estimate", "seek", "project", "plan", "intend", "believe" or similar words concerning future events.

You should not place undue reliance on these forward-looking statements. They are subject to certain risks and uncertainties that may cause actual results to differ materially from past results or our predictions. Factors that could contribute to differences include, but are not limited to, those risks and uncertainties identified under "Additional Factors That May Affect Future Results" in this Quarterly Report. You should also carefully review the risk factors set forth in other documents we file from time to time with the Securities and Exchange Commission particularly the Annual Reports on Form 10-K/A, the Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K.

All statements included in this document are based on information available to us as of the date of this Quarterly Report on Form 10-Q, and we assume no obligation to update such statements, or to update the reasons why actual results could differ from those projected in forward-looking statements.

OVERVIEW

Corio was established in September 1998 and is an enterprise application service provider, or ASP. Our services include the implementation and management of business software for companies. Corio Applications on Demand 2005™ is an operational platform that delivers enterprise applications from leading software vendors as a service. Corio Applications on Demand 2005™ reduces the cost and complexity of enterprise systems and delivers compliance to new control objectives dictated by Sarbanes-Oxley Act of 2002. We provide infrastructure, applications management, professional services and Corio iSRVCE™ technology resource management (TRM) software. By offering software solutions as a monthly service, we enable customers to 'pay-as-you-go,' minimizing upfront project costs, improving return on investment (ROI) and reducing IT cost overall.

Backed by industry leading service level guarantees, Applications on Demand 2005™ simplifies enterprise application management through automation. The key features of our Applications on Demand 2005™ platform are:

- *Productized Offerings:* Configure-to-order product model featuring pre-integrated architectures, proven service scope definitions, and system sizing to make pricing, architecting and ordering enterprise systems simple.
- *Processes:* Repeatable, measured, application management processes to provide consistent delivery quality.
- *Automations*: Automated workflows and scripts to speed delivery, lower cost, and improve quality
- *Technologies*: Component systems and technologies including security solutions, disaster recovery and high availability reduce cost and improve reliability.

- *Corio iSRVCE™*: Corio iSRVCE™ is a Technology Resource Management (TRM) system that provides customers with improved visibility and control over their enterprise systems. iSRVCE 4.0 delivers common request automation enabling subscribers to execute common service tasks through self-service.

We operate through two lines of business:

- Application Management Services—Our application management services consist of ongoing services for business software application systems, which often includes providing the computers, data center facilities and networks to support the software applications and working with our customers to address problems that arise with these applications or the computers or networks that run them.
- Professional Services—Our professional services engagements consist of discrete projects on behalf of our customers such as implementing business software applications in a manner that meets the customer's requirements.

Our business continues to experience a net loss due to the on-going investment into our business. We continue to add customers to our existing customer base, however, the model of our business requires a significant amount of initial investment in capital equipment which may have a negative impact on our net working capital and cash position. We believe this negative impact on our net working capital and cash position will continue as we continue to add new customers.

To drive sales growth and extend our market share, we are making investments in our sales and marketing and professional services areas in fiscal 2004. Our research and development team will continue to focus on further automation and enhancement of our customer interaction processes.

Expanets/Avaya, Inc., a customer that accounted for 12% of revenue for fiscal 2003 and 11% of revenue for the nine months ended September 30, 2004, terminated its customer contract with us effective July 29, 2004. We expect that the loss of this customer will put downward pressure on our revenue in 2004 and beyond, even though Expanets/Avaya recently paid us $2.6 million as part the contract termination, and, based on these payments, we recognized revenue of $1.3 million on this contract in the quarter ended September 30, 2004 and will recognize $1.3 million in the quarter ending December 31, 2004.

During the third quarter of 2004, we entered into an arrangement with AT&T that established a non-exclusive sales and marketing relationship whereby AT&T agreed to work cooperatively with us to sell and support a combined solution around ongoing managed enterprise application services. To date, Corio and AT&T have entered into agreements to provide this joint solution with three new customers. Although we are hopeful that this strategic alliance will continue to result in new customers, there is no certainty that this alliance will achieve any more of its intended benefits.

CRITICAL ACCOUNTING POLICIES

Management's Discussion and Analysis of Financial Condition and Results of Operations are based on our unaudited condensed consolidated financial statements. The preparation of our unaudited condensed consolidated financial statements and related disclosures requires management to make judgments, assumptions and estimates that affect the amounts reported in the condensed consolidated financial statements and accompanying notes.

Estimates are used for, without limitation, the accounting for revenue recognition, allowance for doubtful accounts, certain loss contingencies, valuation allowances and other special charges. Actual results could differ from these estimates. We review these accounting policies we use in reporting our financial results on a regular basis. In addition, our senior management has reviewed these critical accounting policies and related disclosures with our Audit Committee. We have identified the policies below as critical to our business operations and the understanding of our financial condition and results of operations:

- Revenue recognition policy;
- Cash basis revenue recognition customers;
- Allowance for doubtful accounts;
- Loss contingencies; and
- Valuation allowance.

Revenue recognition

We generate revenue from application management services, professional services and other revenues.

Application management services revenue consists of monthly recurring fees for ongoing services, which are recognized as the services are performed in accordance with Security and Exchange Commission's Staff Accounting Bulletin 104 (SAB 104), Revenue Recognition and related interpretations and start-up fees, which are recognized ratably over the term of the customer applications management contract, generally three years upon the commencement of hosting. We also recognize customer prepayments for application management services revenues as the services are performed. In addition, fees for support services, which are also recognized as revenue as the services are performed, are included in application management services revenue. Our application management services may consist of ongoing hardware and software management services for business software application systems, which often includes providing the computers, data center facilities and networks necessary to support the software applications as well as the proactive monitoring, maintenance, security and issue resolution necessary to manage these highly complex business systems. We analyze various customer metrics, such as number of users and amount of data storage, and compare them to the customer's contractual limits. Should the contractual limits be exceeded, we invoice the customer for the overage and recognize the revenue, assuming all other revenue recognition criteria have been met, during the month that the services were performed. Application management services customers are typically billed monthly with net 30 day payment terms.

Professional services and other revenues include revenues from consulting services and implementation services. Revenue from consulting services is recognized using the percentage-of-completion method for fixed-fee arrangements under the cost-to-cost method or as the services are provided for time-and-materials arrangements. Losses resulting from fixed-fee contracts are recorded at the time such losses are estimated to exist. Revenue from time and materials contracts is recognized as services are performed in accordance with SAB 104. We recognize revenue from fixed-fee contracts using a proportional performance method of accounting similar to the percentage of completion method described in Statement of Position 81-1 (SOP 81-1), Accounting for Performance of Construction-Type and Certain Production-Type Contracts. We track the progress of these fixed fee contracts based on a review of detailed project plans and regular review of labor hours incurred to date as compared to total estimated hours. Professional services customers are billed as services are performed in accordance with the terms of their individual contracts.

Cash Basis Revenue Recognition Customers

We recognize revenue from application management services as the services are provided to our customers provided that collection of the receivable is reasonably assured. We regularly monitor the payment activity and credit worthiness of our customers. If we determine that collection of revenue from a particular customer or contract is no longer reasonably assured we designate those customers as "cash basis customers" and start to recognize revenue from that customer on a cash basis, after services have been rendered and payment for services has been received. We consider the following factors in determining whether collection of revenue is no longer reasonably assured from a customer: (i) the customer's payment history and outstanding receivables balance, (ii) the increased probability of non-payment as a result of a deterioration in the customer's financial health as indicated by our review of publicly available information, bankruptcy announcements, or other factors demonstrating a serious weakness in a customer's business such as significant layoffs, decreases in revenues, loss of customers or litigation, or (iii) the increased probability of non-payment due to service-related issues or the receipt of an early termination notice from a customer. If we receive any payment from a cash basis customer in advance of services, we would recognize the payment as revenue as the services are performed. At the time a customer is designated as a cash basis customer any uncollected accounts receivable are evaluated for collectibility. Any amounts that are deemed uncollectible are written off as a reduction to our revenue. The remaining balances remain recorded on an accrual basis and are monitored for collection. Subsequent receipts are applied to these balances before we recognize any additional revenue.

If we believe that there is a reasonable chance that we will receive payment from a customer, even if payment is not reasonably assured and the customer is cash basis, we will typically not terminate the customer and will continue to provide services to that customer. We have set forth below the amount of revenue recognized from cash basis customers for the three and nine months ended September 30, 2004 and 2003 and the period in which the underlying services were performed:

	Three Months Ended September 30 (In thousands)		Nine Months Ended September 30 (In thousands)	
	2004	**2003**	**2004**	**2003**
Cash Basis Revenue Recorded Related to Services Performed in Current Period	$ 3,169	$ 4,661	$ 9,024	$ 10,786
Cash Basis Revenue Recorded Related to Services Performed in Prior Period	478	1,279	2,000	6,451
Total Cash Basis Revenue Recorded	$ 3,647	$ 5,940	$ 11,024	$ 17,237

Revenue earned from cash basis customers but not recognized due to the cash basis designation was $432,000 and $2.1 million as of September 30, 2004 and 2003, respectively. Since revenue related to these invoices is recognized on a cash basis, these amounts have not been included in our accounts receivable balances. In addition, only one of our cash basis customers is obligated to pay recurring application management services fees in advance.

Allowance For Doubtful Accounts

The allowance for doubtful accounts is based on our assessment of the collectibility of specific customer accounts and the aging of the accounts receivable. If there is a deterioration of a major customer's credit worthiness or actual defaults are higher than our historical experience, our estimates of the recoverability of amounts due to us could be adversely affected. We regularly review the adequacy of our allowance for doubtful accounts through the identification of specific receivables where we expect that payment will not be received, in addition to establishing an unallocated reserve that is applied to all amounts that are not specifically identified. In determining specific receivables where collection may not be received, we review past due receivables and give consideration to prior collection history, changes in the customer's overall business condition and the potential risk associated with the customer's industry, among other factors. An unallocated reserve is established for all amounts, which have not been specifically identified, based on applying a graduated percentage to each invoice's relative aging category. The allowance for doubtful accounts reflects our best estimate as of the reporting dates. Changes may occur in the future, which may make us reassess the collectibility of amounts and at which time we may need to provide additional allowances in excess of that currently provided. At September 30, 2004 and December 31, 2003, our allowance for doubtful accounts was $654,000 and $591,000, respectively.

Loss Contingencies

We are subject to various loss contingencies such as the risks associated with estimates included in both our restructuring liability and our professional services fixed fee contracts. We consider the likelihood of the loss or the incurrence of a liability as well as our ability to reasonably estimate the amount of loss in determining loss contingencies. An estimated loss is accrued when it is probable that a liability has been incurred and the amount of loss can be reasonably estimated.

For our office lease restructuring liability, our estimate is based on our contracted lease obligation offset by estimated sublease income over the lease term. We increased our office lease restructuring liability in the first quarter of 2003 as a result of the sublease agreement signed in May 2003 because the total sublease income for the restructuring period was less than initially estimated.

In addition, since we perform some of our professional services on a fixed fee basis, if we incur more costs than estimated, our profitability will suffer. We track our progress to completion on such arrangements by detailing individual project plans for each arrangement and then regularly comparing the labor hours actually spent on a project against the number of hours we estimate to complete the project. We believe this process results in a reasonable estimate of our progress to completion. When estimates of costs to complete the project indicate that a loss will be incurred, these losses are estimated and recognized immediately. Additionally, we regularly evaluate current information available to us to determine whether such recorded losses should be adjusted. In the first quarter of 2004, based on our evaluation of the open professional services contracts, we reduced our accruals for contract losses by $153,000, which resulted in a corresponding reduction to professional services expenses for the three months ended March 31, 2004. As of September 30, 2004, no accrual for contract losses was required.

We evaluate long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of any asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

Valuation Allowance

We provided a valuation allowance against our entire net deferred tax asset, primarily consisting of net operating loss carryforwards. The valuation allowance was recorded given the losses we incurred through the current quarter, and our uncertainties regarding future operating profitability and taxable income. If we do not achieve profitability or if we were to consummate certain types of mergers, we will not fully realize the deferred tax benefits.

Selected Financial Data

The following tables (in thousands, except percentages) set forth, for the periods presented, certain data from our condensed consolidated statements of operations as percentages of total revenues.

	Three Months Ended September 30, 2004 Amount	Three Months Ended September 30, 2004 Percentage of Total Revenues	Three Months Ended September 30, 2003 Amount	Three Months Ended September 30, 2003 Percentage of Total Revenues	Three Months Ended September 30, 2004 versus September 30, 2003 Dollar Change	Three Months Ended September 30, 2004 versus September 30, 2003 Percentage Change
REVENUES:						
Application management services	$ 14,379	81 %	$ 14,295	92 %	$ 84	1 %
Professional services and other	3,445	19 %	1,245	8 %	2,200	177 %
Total revenues	17,824	100 %	15,540	100 %	2,284	15 %
COSTS AND EXPENSES:						
Application management services	11,800	66 %	11,210	72 %	590	5 %
Professional services and other	2,855	16 %	730	5 %	2,125	291 %
Research and development	562	3 %	1,123	7 %	(561)	(50)%
Sales and marketing	2,417	14 %	2,125	14 %	292	14 %
General and administrative	3,274	18 %	2,339	15 %	935	40 %
Restructuring charges	714	4 %	--	-- %	714	100 %
Amortization of stock-based compensation	--	0 %	(34)	-- %	34	(100)%
Amortization of intangible assets	273	2 %	367	2 %	(94)	(26)%
Total operating expenses	21,895	123 %	17,860	115 %	4,035	23 %
Loss from operations	(4,071)	(23)%	(2,320)	(15)%	(1,751)	75 %
Interest and other income	161	1 %	136	-- %	25	18 %
Interest and other expense	(394)	(2)%	(73)	0 %	(321)	440 %
Income tax expense	--	0 %	--	0 %	--	0%
Net loss	$ (4,304)	(24)%	$ (2,257)	(15)%	$ (2,047)	91 %

	Nine Months Ended September 30, 2004 Amount	Nine Months Ended September 30, 2004 Percentage of Total Revenues	Nine Months Ended September 30, 2003 Amount	Nine Months Ended September 30, 2003 Percentage of Total Revenues	Nine Months Ended September 30, 2004 versus September 30, 2003 Dollar Change	Nine Months Ended September 30, 2004 versus September 30, 2003 Percentage Change
REVENUES:						
Application management services	$ 43,069	81 %	$ 45,762	89 %	$ (2,693)	(6)%
Professional services and other	10,025	19 %	5,833	11 %	4,192	72 %
Total revenues	53,094	100 %	51,595	100 %	1,499	3 %
COSTS AND EXPENSES:						
Application management services	34,692	65 %	36,333	70 %	(1,641)	(5)%
Professional services and other	8,568	16 %	4,455	9 %	4,113	92 %
Research and development	1,747	3 %	3,819	7 %	(2,072)	(54)%
Sales and marketing	7,848	15 %	6,632	13 %	1,216	18 %
General and administrative	8,508	16 %	6,917	13 %	1,591	23 %
Restructuring charges	714	1 %	2,334	5 %	(1,620)	(69)%
Amortization of stock-based compensation	3	-- %	445	1 %	(442)	(99)%
Amortization of intangible assets	1,191	2 %	1,257	2 %	(66)	(5)%
Total operating expenses	63,271	118 %	62,192	120 %	1,079	2 %
Loss from operations	(10,177)	(18)%	(10,597)	(20)%	420	(4)%
Interest and other income	384	1 %	518	1 %	(134)	(26)%
Interest and other expense	(458)	(1)%	(285)	(1)%	(173)	61 %
Income tax expense	(115)	0 %	--	0 %	(115)	100 %
Net loss	$ (10,366)	(20)%	$ (10,364)	(20)%	$ (2)	0 %

RESULTS OF OPERATIONS

Revenues

Total revenue was $17.8 million and $15.5 million for the three months ended September 30, 2004 and 2003, respectively, an increase of $2.3 million. Total revenue was $53.1 million and $51.6 million for the nine months ended September 30, 2004 and 2003, respectively, an increase of $1.5 million. One of our customers Expanets/Avaya, Inc., which accounted for 11% of our total revenues for the three and nine month periods ended September 30, 2004, terminated its contract effective July 29, 2004.

Application Management Services Revenues. Revenues from our application management services, or AMS, were $14.4 million for the three months ended September 30, 2004, including $3.6 million recognized as a result of payments from cash basis customers. The $3.6 million of AMS revenue recognized from cash basis customers includes $1.9 million in non-recurring revenues from customer contract terminations. Included in the $1.9 million in non-recurring revenue was $1.3 million from Expanets/Avaya, Inc. For the three months ended September 30, 2003, our revenues of $14.3 million included $5.9 million recognized as a result of payments from cash basis customers. Included in the $5.9 million recognized from cash basis customers was $1.5 million in non-recurring revenues from customer contract terminations. The $0.1 million increase in application management services revenues for the three months ended September 30, 2004 was primarily due to an increase in non-recurring settlement revenue of $0.4 million, primarily due to the payment received from Expanets/Avaya, Inc, which was offset by a decrease of recurring application management services revenues of $0.3 million, primarily due to the termination of the Expanets/Avaya, Inc contract netted against the increase of revenue from new business.

Revenues from our application management services, or AMS, were $43.1 million for the nine months ended September 30, 2004, including $11.0 million recognized as a result of payments from cash basis customers. The $11.0 million recognized from cash basis customers includes $3.2 million in non-recurring revenues from customer contract terminations. For the nine months ended September 30, 2003, our AMS revenues of $45.8 million included $16.8 million recognized as a result of payments from cash basis customers. Included in the $16.8 million recognized from cash basis customers was $2.5 million in non-recurring revenues from customer contract terminations. The $2.7 million decrease in application management services revenues for the nine months ended September 30, 2004 was due in part to a decrease of $2.5 million in the hosting fees for Quadrem. In addition, we recognized $1.1 million in the nine months ended September 30, 2003 from a former Qwest Cyber Solutions, or QCS, customer. This customer was in the process of terminating its AMS contract with QCS at the time we acquired the contract as part of the September 2002 QCS acquisition. As a result, we recognized $1.1 million in monthly hosting fees for the contract through the February 28, 2003 termination date. The offset to these two revenue decrease items was the increase in new business

Professional Services and Other Revenues. Our professional services and other revenues were $3.4 million for the three months ended September 30, 2004, including $37,000 recognized as a result of payments from cash basis customers, compared to $1.2 million for the three months ended September 30, 2003, including $51,000 recognized as a result of payments from cash basis customers. The $2.2 million increase in professional services revenues was primarily due to additional customers obtained through our acquisition of Nexus Technology, Inc. as well as the addition of other new customers and projects. Our professional services and other revenues were $10.0 million for the nine months ended September 30, 2004, including $92,000 recognized as a result of payments from cash basis customers, compared to $5.8 million for the nine months ended September 30, 2003, including $486,000 recognized as a result of payments from cash basis customers. The $4.2 million increase in professional services revenues was primarily due to additional customers we obtained through our acquisition of Nexus Technology, Inc. as well as the addition of new customers and projects. At September 30, 2004 and December 31, 2003, we had balances of $533,000 and $76,000, respectively, for deferred professional services revenues resulting from customer payments that we required in advance of providing our professional services work. We anticipate that professional services revenue and the associated margins will fluctuate significantly from period to period depending on the timing and size of projects, the amount of such work completed by independent third parties and other factors.

Costs and Expenses

Total operating expenses were approximately $21.9 million and $17.9 million for the three months ended September 30, 2004 and 2003, respectively, and approximately $63.3 million and $62.2 million for the nine months ended September 30, 2004 and 2003, respectively.

*Application Management Services***.** Application management services expenses, excluding stock-based compensation of $0 and $7,000 for the three months ended September 30, 2004 and 2003, respectively, were $11.8 million for the three months ended September 30, 2004 and $11.2 million for the three months ended September 30, 2003. The $0.6 million increase in expenses for the three months ended September 30, 2004 compared to the three months ended September 30, 2003 was primarily attributable to a $0.3 million increase in internal staff cost and an $0.6 million increase in cost of operating our datacenters which were offset by a $0.6 million reduction in depreciation. A number of our assets were purchased in 2000 and had a three-year useful life. The reduction in depreciation was partially offset by an increase in staff costs due to higher headcount and a company-wide 4% salary increase effective April 1, 2004. Application management services expenses, excluding stock-based compensation of $1,000 and $65,000 for the nine months ended September 30, 2004 and 2003, respectively, were $34.7 million for the nine months ended September 30, 2004 and $36.3 million for the nine months ended September 30, 2003. The $1.6 million decrease is due primarily to a $2.3 million reduction in depreciation expense and a $0.6 million decrease in equipment rental and maintenance cost offset by a $0.8 million increase in datacenter cost and an increase of $0.5 million in staff costs.

*Professional Services and Other***.** Professional services and other expenses were $2.9 million for the three months ended September 30, 2004 and $0.7 million for the three months ended September 30, 2003. The $2.2 million increase was due primarily to an increase of $0.4 million in internal staff costs and a $1.2 million increase in outside contractors associated with delivering higher revenue from our professional services contracts in the three months ended September 30, 2004 in addition to a downward adjustment to our provision for contract losses of $0.7 million in the three months ended September 30, 2003. There were no professional services stock-based compensation charges for the three or nine months ended September 30, 2004 or 2003. Professional services and other expenses were $8.6 million for the nine months ended September 30, 2004 and $4.5 million for the nine months ended September 30, 2003. The $4.1 million increase is primarily the result of a $3.4 million increase in outside contractors associated with delivering higher revenue and a $0.6 million increase in internal staff cost offset by a downward adjustment to our provision for contract losses of $0.5 million in the nine months ended September 30, 2003.

Research and Development. Research and development expenses, excluding stock-based compensation charges reductions of $0 and $11,000 for the three months ended September 30, 2004 and 2003, respectively, were $0.6 million for the three months ended September 30, 2004 and $1.1 million for the three months ended September 30, 2003. Research and development expenses as a percentage of total revenues were 3% for the three months ended September 30, 2004 and 7% for the three months ended September 30, 2003. The $0.5 million expense decrease was mainly due to the reduction in personnel costs partly due to moving tasks to our office in India. Research and development expenses, excluding stock-based compensation charges (expense reductions) of $1,000 and $2,000 for the nine months ended September 30, 2004 and 2003, respectively, were $1.8 million for the nine months ended September 30, 2004 and $3.8 million for the nine months ended September 30, 2003. The majority of the $2.0 million decrease is the result of a $1.4 million decrease in staff costs, a $0.3 million decrease in external contractors and a $0.1 million decrease in depreciation expense.

Sales and Marketing Expenses. Sales and marketing expenses, excluding stock-based compensation of $0 and $27,000 for the three months ended September 30, 2004 and 2003, respectively, were $2.4 million for the three months ended September 30, 2004 and $2.1 million for the three months ended September 30, 2003. Sales and marketing expenses as a percentage of total revenues were 14% for the three months ended September 30, 2004 and 14% for the three months ended September 30, 2003. The $0.3 million increase was primarily due to a $0.5 million increase in personnel costs as additional headcount was added to provide increased subject matter experts in Peoplesoft, Oracle and SAP areas to assist in the sales process offset by a $0.2 million reversal of an travel-related accrual that was no longer required. Sales and marketing expenses, excluding stock-based compensation of $1,000 and $187,000 for the nine months ended September 30, 2004 and 2003, respectively, were $7.8 million for the nine months ended September 30, 2004 and $6.6 million for the nine months ended September 30, 2003. The $1.2 million increase was primarily due to a $1.0 million increase in personnel costs, a $0.6 million increase in commissions expense and a $0.4 million decrease in amortization expense associated with the warrants issued to Cap Gemini Ernst & Young U.S., L.L.C. on September 27, 2000.

*General and Administrative Expenses***.** General and administrative expenses, excluding stock-based compensation (credit) of $0 and ($79,000) for the three months ended September 30, 2004 and 2003, respectively, were $3.3 million for the three months ended September 30, 2004 and $2.3 million for the three months ended September 30, 2003, respectively. General and administrative expenses as a percentage of total revenues were 18% for the three months ended September 30, 2004 and 13% for the three months ended September 30, 2003. The $1.0 million increase in general and administrative expenses was mainly due to a $0.3 million increase in staff costs in finance and professional services general management, a $0.3 million increase in telecom costs, a $0.6 million increase in professional legal and accounting fees relating to the compliance requirements of the Sarbanes-Oxley Act offset by a $0.1 million reduction in occupancy costs due to sub-leasing and restructuring a portion of our San Carlos facility space in fiscal year 2003. General and administrative expenses, excluding stock-based compensation of $1,000 and $191,000 for the nine months ended September 30, 2004 and 2003, respectively, were $8.5 million for the nine months ended September 30, 2004 and $6.9 million for the nine months ended September 30, 2003, respectively. The $1.6 million increase was mainly due to a $0.6 million increase in staff costs, a $0.5 million increase in telecom costs, a $1.3 million increase in professional legal and accounting fees offset by a $0.5 million reduction in occupancy cost, and a $0.4 million reduction in depreciation.

*Restructuring Charges***.** In February 2004, we terminated our lease prior to the end of its term for our facilities in Arizona and simultaneously entered into a new lease and facilities in Arizona. No termination fees were incurred during the termination of the old lease. Capitalized fixed assets associated with the old facilities were held for resale due to the interest of several parties in purchasing the fixed assets. Subsequently, during September 2004, we determined that the fixed assets will not be sold, and therefore, did not have any remaining value. We disposed of the fixed assets associated with our old Arizona facilities during the three months ended September 30, 2004 and incurred a non-cash restructuring charge of approximately $714,000.

In May 2003, we signed an agreement to sublease the vacated portion of our headquarters facility through the end of our lease, which is March 2010. During the quarter ended June 30, 2003, we adjusted our estimated loss related to the vacated space and recorded an additional restructuring charge of $2.5 million to reflect the terms of this new sublease agreement. The impact of this charge was partially offset by the favorable resolution of our liability with respect to various capital leases, which resulted in a reduction of $139,000 to reduce the previously established restructuring reserve. There were no additional restructuring charges recorded during the three or nine months ended September 30, 2004. The cash payments were approximately $177,000 for the three months ended September 30, 2004 and approximately $532,000 for the nine months ended September 30, 2004.

*Amortization of Stock-Based Compensation***.** Amortization of deferred stock-based compensation was $0 and ($34,000) for the three months ended September 30, 2004 and 2003, respectively. Amortization of deferred stock-based compensation was $3,000 and $445,000 for the nine months ended September 30, 2004 and 2003, respectively. The deferred charges for employee options are being amortized to expense using the graded vesting approach prescribed by FASB Interpretation No. 28. Deferred stock-based compensation was fully amortized in March 2004.

*Amortization of Other Intangibles***.** Amortization of intangible assets was $273,000 for the three months ended September 30, 2004 and $367,000 for the three months ended September 30, 2003. Amortization of intangible assets was $1.2 million for the nine months ended September 30, 2004 and $1.3 million for the nine months ended September 30, 2003. In November 2003, we recorded an intangible asset of $2.6 million for application management services and professional services contracts acquired in connection with our acquisition of Nexus. This intangible asset is being amortized over estimated lives ranging from four months to five years. In September 2002, we recorded an intangible asset of $2.7 million for contracts acquired in connection with our acquisition of QCS, which is included in other assets in the accompanying, condensed consolidated balance sheet. This intangible asset was amortized over an 18 month period that ended February 2004.

*Interest and Other Income and Expenses***.** Net interest and other income and (expense) were ($233,000) for the three months ended September 30, 2004 and $63,000 for the three months ended September 30, 2003. The $296,000 decrease was primarily due to a $292,000 loss incurred on the disposal of obsolete capital assets during the three months ended September 30, 2004. Net interest and other income and expense were ($74,000) for the nine months ended September 30, 2004 and $233,000 for the nine months ended September 30, 2003. The $307,000 decrease was primarily due to a $292,000 loss incurred on the disposal of obsolete capital assets and to a lesser extent, a lower average cash and short term investment balance.

*Income Taxes***.** Since inception, we have incurred net losses for federal and state tax purposes, and we anticipate continued losses for the foreseeable future. We recognized $0 tax expense for the three months ended September 30, 2004 and 2003, respectively. We recognized $115,000 and $0 of tax expense for the nine months ended September 30, 2004 and 2003, respectively. This tax expense is primarily for state and local purposes, which is determined based on gross receipts or capital.

Related Party. In the ordinary course of business, we recorded revenue of $0 and $16,000 for the three months ended September 30, 2004 and 2003, respectively, arising from transactions with one company with which we have directors in common. We recorded revenue of $55,000 and $32,000 for the nine months ended September 30, 2004 and 2003, respectively, arising from transactions with such companies. We paid $134,000 and $0 for the three months ended September 30, 2004 and 2003, respectively, to a company with which we have directors in common. For the nine months ended September 30, 2004 and 2003, we paid $189,000 and $177,000, respectively, to companies with which we have directors in common. At September 30, 2004, we had $0 in accounts receivable and $0 in accounts payable from such related parties.

LIQUIDITY AND CAPITAL RESOURCES

As of September 30, 2004, we had cash and cash equivalents, short-term investments, and restricted cash of $36.1 million, a decrease of $6.6 million from $42.7 million as of December 31, 2003. The $6.6 million decrease was primarily the result of $9.0 million in cash provided by financing activities offset by $12.1 million of cash used in investing activities and $4.9 million of cash used by operating activities.

Net cash used in operating activities was $4.9 million for the nine months ended September 30, 2004 compared to $0.9 million used in operating activities for the nine months ended September 30, 2003. The $4.0 million net change was primarily due to an increase in accounts receivable offset by lower payments of accounts payable and payments of professional services and equipment purchases included in accrued expenses.

We lease office facilities and fixed assets under non-cancelable operating and capital leases. Rental expense under operating lease agreements was $1.0 million and $0.9 million for the three months ended September 30, 2004 and 2003, respectively. Rental expense for the nine month period ended September 30, 2004 and 2003 was $2.6 million and $3.0 million, respectively.

The following summarizes our principal facilities and equipment contractual commitments, excluding open orders for purchases to support normal operations, as of September 30, 2004 (in thousands):

	Payments Due By Period						
		Three months Ending December 31,	Years Ending, December 31,				
	Total	2004	2005	2006	2007	2008	Thereafter
Capital lease obligations.....................	$ 492	$ 93	$ 283	$ 116	$ --	$ --	$ --
Operating lease obligations.................	24,167	1,069	4,335	4,320	4,426	4,332	5,685
Equipment Operating leases................	47	18	28	1	--	--	--
Total contractual cash obligations......	$ 24,706	$ 1,180	$ 4,646	$ 4,437	$ 4,426	4,332	$ 5,685

The following summarizes our principal vendor contractual commitments as of September 30, 2004 (in thousands):

	Payments Due By Period						
		Three months Ending December 31,	Years Ending, December 31,				
	Total	2004	2005	2006	2007	2008	Thereafter
Vendor Commitments........................	$ 9,829	$ 1,308	$ 5,834	$ 1,406	$ 1,007	$ 274	$ --

Net cash used in investing activities was $12.1 million for the nine months ended September 30, 2004 compared to $11.0 million used in investing activities for the nine months ended September 30, 2003. The $1.1 million increase was primarily related to equipment purchases of $10.2 million in the nine months ended September 30, 2004 compared to equipment purchases of $3.2 million in the nine months ended September 30, 3003. The increase in equipment purchases in the nine months ended September 30, 2004 relate primarily to increased customer contracts booking related to first nine months of fiscal 2004 and internal use purposes. Offsetting the increased investment in equipment purchases in the nine months ended September 30, 2004 compared to nine months ended September 30, 2003 were a net reduction in the sale and purchase of short-term investments of $6.2 million in the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003.

Net cash provided by financing activities was $9.0 million for the nine months ended September 30, 2004 compared to $3.5 million used for the nine months ended September 30, 2003. The $12.5 million change in cash provided by financing activities consisted primarily of the proceeds from the issuance of common stock under our employee stock purchase plan and exercise of stock options by our employees, reduced payments on capital leases as buy-outs increased, and $7.0 million in borrowings from a bank term commitment payable entered into in the first quarter of fiscal 2004 for equipment purchases.

On March 17, 2004, we entered into a $7 million term commitment payable with Wells Fargo Bank. The proceeds from this financing have been used to finance the purchase of new equipment and software. In connection with the term commitment payable, we issued a promissory note dated March 17, 2004 for a loan up to $7 million. Under the term commitment payable we could draw against the note through September 2004. Outstanding balances under the note will accrue interest at a rate of LIBOR plus 1.75%, however, the interest rate can be changed, at our option, to a floating rate of prime minus 0.25%. Additionally, we are obligated to pay interest on outstanding balances until October 1, 2004, at which time, the term commitment payable converts into a term loan with principal and interest payments due monthly. The outstanding principal balance under the term loan and interest payments will be payable over 30 months. The term loan interest rate can either be LIBOR or fixed. Principal is due in full February 2007. As of September 30, 2004, the outstanding balance was $7.0 million and the interest rate was 4.5%. This agreement contains various financial covenants regarding liquidity, net worth and results from operations.

Covenants associated with this loan require that our results from operations generate certain levels of EBITDA (earnings before interest, taxes, depreciation and amortization) on a quarterly basis. We did not meet the EBITDA covenant for the quarters ended June 30, 2004 and September 30, 2004 and obtained waivers from Wells Fargo Bank related to each covenant violation. We have classified this obligation as current as we have future quarterly EBITDA covenants that we do not believe we will be able to comply with due to increased operating expenses and the loss of revenue associated with the customer contract with Expanets/Avaya, Inc., which terminated on July 29, 2004. We are in discussions with Wells Fargo Bank regarding how to address anticipated future EBITDA or liquidity covenant violations. We have $28.3 million of unrestricted cash, cash equivalents and short-term investments as of September 30, 2004.

Except for equipment operating leases, we have no off balance sheet financing arrangements (see Note 8 in this Quarterly Report).

On October 22, 2003, we completed the purchase of the assets and the assumption of certain liabilities of Nexus. We paid Nexus approximately $10.2 million, consisting of $1.9 million in cash and 2,921,390 shares of our common stock, including $177,000 related to legal expenses. In addition, Nexus is entitled to receive an earn-out payment of up to $2.0 million payable in shares of our common stock contingent upon specified revenue milestones for the three-month period ending December 31, 2004 from identified existing and prospective customers of Nexus. In accordance with the terms of the asset purchase agreement, $500,000 of the purchase price was also deposited into an escrow account, all of which has been distributed.

We expect that our current cash balances and existing debt arrangements will be sufficient to meet our cash requirements for at least the next 12 months. However, any major changes in the nature of our business or structure, a significant reduction in demand for our services, the need for significant new capital expenditures, or mergers or acquisitions could further utilize our cash reserves. To the extent we require additional cash; there can be no assurances that we will be able to obtain such financing on terms favorable to us, or at all.

Risks Related to Our Business

We expect to continue to incur losses and experience negative cash flow and we may never be profitable.

We have spent significant funds to date to develop and refine our current services, to create and run our operations organization, to build and run a professional services organization and to develop and run our sales and marketing resources. We have incurred significant operating and net losses and negative cash flow and have not achieved profitability. As of September 30, 2004, we had an accumulated deficit of $270 million.

We expect to continue to invest significantly in our organization to provide services, enhance current services and expand our service offerings. We also may hire additional people in certain areas of our company in order to support our business and promote and sell our services. In addition, we expect to continue to incur significant fixed and other costs associated with customer acquisitions and with the implementation and configuration of software applications, and ongoing services, for customers. As a result of all of these factors, to achieve operating profitability on a consistent basis, excluding non-cash charges, we will need to increase our customer base and number of customers, to increase our revenue, to decrease our overall costs of providing services, including the costs of our licensed technology and our operations and the costs of customer acquisitions. We cannot assure you that we will be able to increase our revenues or increase our operating efficiencies in this manner. Also, we may continue to invest in our business faster than we anticipate growth in our revenues, and we may continue to incur significant losses and negative cash flow for the foreseeable future and we may never be profitable.

Because of the nature of our customer base, we may experience greater than expected customer loss and instability as well as difficulties collecting fees, which could result in reduced revenues.

A significant portion of our current revenue is derived from technology and middle-market companies. Middle-market companies consist of companies or divisions with annual revenues of between approximately $200 million and $1 billion. Technology and middle-market companies may be more likely to be acquired, experience financial difficulties or cease operations than companies that are larger and better established or are in more stable industries. For instance, technology and middle-market companies may experience difficulties in raising capital needed to fund their operations. As a result, our client base will likely be more volatile than those companies whose customer base consists of more mature and established businesses. Over the past four years we experienced early terminations of customer agreements with approximately one hundred customers, many of which entered into agreements with us in 1999 and 2000 and whose terminations were based on the dot com crash and many of which are no longer in business. We expect additional customer agreements to terminate in the future. If we continue to experience greater than expected customer loss or an inability to collect fees from our customers in a timely manner because of this volatility, our operating results could be seriously harmed.

The loss of key customers could reduce our revenues and could be perceived as a loss of momentum for our business.

We have experienced customer attrition in the past and expect to experience it in the future. Historically, we have generated a substantial portion of our revenues from a limited number of customers and we expect that in the future a limited number of customers will continue to account for a substantial portion of our revenues. As a result, if we lose a major customer for any reason, including non-renewal of a customer contract, failure to meet performance requirements, or because of an acquisition or bankruptcy, our revenues could be adversely affected. We may lose customers if they are acquired by a company which does not need access to the kinds of services we provide, either because the acquiring company has in-house capabilities, existing contractual arrangements that preclude them from using our services, or for a variety of other reasons. If we do not grow our revenue, we may never achieve profitability or positive cash flow and therefore the loss of any significant customers could adversely affect our operating results. In addition, our potential customers and investors may perceive any customer loss as a loss of momentum in our business, which may adversely affect future opportunities to sell our products and services and cause our stock price to decline. We cannot be certain that customers that have accounted for significant revenues in past periods will continue to generate revenues in any future period.

For example, one of our customers, Quadrem, who represented 11% of total revenues in fiscal 2002, had its contract expire in May 2003. Although Quadrem renewed for a short-term contract, the new contract was for significantly less recurring monthly revenue. In addition, another customer, Expanets, a customer that accounted for 12% of total revenues for fiscal 2003, was acquired by Avaya, Inc. in November 2003. Subsequently, Expanets/Avaya, Inc. terminated its customer contract as of July 29, 2004. The loss of Expanets/Avaya, Inc. as a customer, or the future loss of any other significant customer, or any significant reduction in fees paid to us by a significant customer, will have a significant adverse effect on our ability to achieve profitability and positive cash flow.

Our failure to collect payments for our services from "cash basis" customers could significantly decrease our revenues and profitability.

In the event we decide payment by a customer is no longer reasonably assured then we designate that customer as a "cash basis" customer. Historically we have generated a significant portion of our revenue from payments by cash basis customers. The percentage of our customers designated as cash basis customers as of the end of September 30, 2004 was 12% and for the years ended December 31, 2003, 2002 and 2001 was 12%, 29% and 42%, respectively. For the quarter ended September 30, 2004 we recorded revenue of $3.6 million (20% of revenues) related to services provided to cash basis customers. For the nine months ended September 30, 2004 we recorded revenue of $11.0 million (21% of revenues) related to services provided to cash basis customers. For the years ended December 31, 2003, 2002 and 2001, we recorded revenue of $22.2 million (32% of total revenue), $17.0 million (31% of total revenue) and $16.6 million (32% of total revenue), respectively, related to services provided to cash basis customers.

For the quarter ended September 30, 2004, we determined not to recognize approximately $432,000 in revenue related to services provided during this period, based on our policies regarding customers designated as cash basis customers for which we did not receive payment. For the 2003 fiscal year we determined not to recognize approximately $1.4 million in revenue related to services provided during this period to cash basis customers. For fiscal 2002, this amount was $3.0 million and for fiscal 2001 it was $2.3 million. A significant portion of our customer base remains on a cash basis and we expect to continue to have a significant number of customers on a cash basis going forward. For these customers we are at risk of not receiving payment for services we have already performed. Failure by these customers to pay could decrease revenue and result in our having incurred costs to provide services without being compensated for those services, which could adversely affect our ability to become profitable.

We may experience issues with our financial controls that could harm our financial condition and results of operations and have a negative effect on the trading price of our stock.

Our former auditors have noted certain matters involving internal controls and operations that they consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to auditors' attention relating to significant deficiencies in the design or operation of internal controls that, in the auditor's judgment, could adversely affect the company's ability to initiate, record, process, and report financial data accurately, on a timely basis and consistent with regulatory requirements. For example, our former auditors had identified as a significant deficiency our lack of adequate staffing within our finance department during their review of our financial statements for the three and six months ended June 30, 2004. Please see the disclosure we have provided in Item 4 "Controls and Procedures" of this quarterly report for more information on these significant deficiencies.

We are continuing to work to improve our internal controls and to address the significant deficiencies identified by our former auditors. We have taken measures to improve our financial reporting and management capabilities and we are in the process of instituting changes to our internal controls in order to try to satisfy our obligations as a public company, including the requirements associated with the Sarbanes-Oxley Act of 2002 such as compliance with Section 404 of the Sarbanes-Oxley Act by the end of this year. For example, we are in the process of expanding the documentation of our internal processes, and we are actively recruiting additional financial and accounting personnel to support our finance team. To sufficiently address the issues with our internal controls, we will need to continue to improve our financial and managerial controls, reporting systems and procedures, and documentation thereof, and will need to continue to expand, train and manage our finance team effectively.

We cannot be certain that the measures we are taking and will take in the future will ensure that we implement and continue to maintain adequate controls over our financial processes and reporting. If we fail to implement and continue to maintain adequate internal controls, this could have a material adverse effect on our business, results of operations and financial conditions and could prevent us from releasing our financial information and SEC reports in a timely and accurate manner and in compliance with regulatory requirements. This could also adversely affect our ability to sell our services and implement our business plan successfully and in a manner that achieves profitability, and could impair our ability to detect and prevent fraud.

The fact that we operate in a relatively new and rapidly evolving industry exposes us to risks that may result in our inability to successfully execute on our business model, which could adversely affect our operating results.

The ASP market is relatively new and has not yet received universal acceptance by the enterprises we target. An investor in our common stock must consider these facts as well as the risks, uncertainties, expenses and difficulties frequently encountered by companies in their early stages of development, particularly companies in new and rapidly evolving markets such as the market for Internet-based software application services. Some of the risks and difficulties relate to our potential inability to:

- acquire and retain customers, particularly larger, more established companies desirable to create a stable revenue and customer base;
- acquire new customers at a rate sufficient to create growth taking into account loss of customers;
- reduce costs associated with the delivery of services to our customers;
- expand and maintain our pipeline of sales prospects in order to promote greater predictability in our period-to-period sales levels;
- acquire or license third party software applications, hardware, and networking and data center services at a reasonable cost or at a structure beneficial to us;
- complete successful implementations of software applications in a manner that is repeatable and scalable;
- integrate successfully software applications we manage with each other and with our customers' existing systems;
- continue to offer new services that complement our existing offerings;
- increase awareness of our brand; and
- maintain our current, and develop new, strategic relationships.

We cannot assure you that we will successfully address these risks or difficulties. If we fail to address any of these risks or difficulties adequately, we will likely be unable to execute our business model.

If we are unable to adjust our spending to offset future revenue shortfalls, our short-term operating results could be adversely affected causing our stock price to fall.

We expend significant sums in order to run our business and to promote future growth in our business, operations, professional services, research and development, and sales and marketing organizations. Although we are monitoring our spending, we expect to continue to expend significant sums on these activities. Because the expenses associated with these activities are relatively fixed in the short-term, we may be unable to adjust spending quickly enough to offset any unexpected shortfall in revenue growth or any decrease in revenue levels. As our operating results fluctuate, they may fall short of the expectations of public market analysts or investors. If this occurs, the price of our common stock may fall.

Our quarterly operating results may fluctuate, which could cause our stock price to fall.

Our financial results will vary due to factors such as the nature of our services and the timing of payments received from cash basis customers. For individual customers, we may recognize professional services revenues associated with the implementation of our applications during the early months of our engagement. We then recognize monthly fees from these customers, consisting primarily of application management services revenues, over the balance of the contractual relationship. As a result, for some customers we have a high proportion of up-front professional services revenues associated with implementation. We expect that our financial results may continue to vary over time as monthly fees vary in relation to other revenue. In addition, third parties also provide professional services for some of our application management services customers, and whether professional services will be provided by us or by third parties may be difficult to predict. Changes in our revenue mix from professional services revenues to application management services revenues could be difficult to predict and could cause our quarterly results and stock price to fluctuate.

Other important factors that could cause our quarterly results and stock price to fluctuate materially include:

- the timing of obtaining, implementing and establishing connectivity with individual customers;
- the loss of or change in our relationship with important customers and our ability or inability to collect termination fees from terminating customers;
- any increase or decrease in termination fees, settlement fees or judgments paid in a quarter versus other quarters;
- the timing and magnitude of expanding our operations and of other capital expenditures;
- the timing and amount of payments received from cash basis customers as well as the change in composition of these customers;
- costs, including license fees, relating to the software applications we use;
- changes in our pricing policies or those of our competitors;
- potential changes in the accounting standards associated with accounting for stock options, stock or warrant issuances and for revenue recognition; and
- accounting charges we may incur in the future relating to stock options, stock or warrant issuances.

Our financial results may vary over time as our business model evolves, which could cause our stock price to fall.

Our financial results could vary over time as our ASP business and financial models mature and evolve. For example, we historically included a broad range of customer support in our fixed monthly fees but now bill certain customers for support services in excess of specified limits in certain circumstances. As another example, we have unbundled the cost of enterprise software licenses from our fixed monthly fee and require our customers to obtain licenses to enterprise software applications directly from third party software providers. Any such changes to our business or financial model would likely cause financial results to vary, which could cause our stock price to fall.

In this regard, from time to time we negotiate with some of our major third party software vendors to modify the pricing and other terms currently in place with these vendors. We may agree to restructure our current arrangements with some of our third party software providers. For example, we have migrated substantially all of our customers from a model whereby some rent enterprise application licenses from us to a model whereby they all purchase the licenses directly from independent software vendors. Such pricing structures or business models may not in fact be more beneficial to us and may ultimately hinder our ability to become profitable.

The loss of access to, or the obsolescence of, third party software necessary to deliver our services may adversely affect our revenues and increase our costs.

We offer our customers software application services for applications from third parties such as PeopleSoft, Oracle, SAP, Ariba and Siebel Systems. We have agreements in place with certain third party software vendors, and our agreements with third party software vendors are non-exclusive, are for limited terms and typically permit termination in the event of our breach of the agreements. Additionally, a substantial majority of our customers are "host-only", whereby they must obtain licenses directly from independent software vendors such as PeopleSoft, Oracle, SAP, Ariba and Siebel, and, in these situations, we may rely on the independent software vendors to consent to allow us to access the software to provide our services. If we lose the right to host the software from third party software vendors, if the cost of licensing the software applications becomes prohibitive, or if we change the vendors from whom we currently license software, our business and our customers' businesses could be significantly disrupted, which could harm our revenues and increase our costs. Our financial results may also be harmed if the cost structure we negotiate in the future with the third party software vendors changes in a manner that is less beneficial to us compared to our current cost structure with software vendors. We cannot assure you that our services will continue to support the software of our third party vendors, or that we will be able to adapt our own offerings to changes in third party software. In addition, if our vendors were to experience financial or other difficulties, it could adversely affect the availability of their software. It is also possible that improvements in software by third parties with which we have no relationship could render the software we offer to our customers less compelling or obsolete.

The limits imposed on our uses of the third party software necessary to deliver our services may impair our growth and operating results.

Certain agreements we have for the third party software for which we provide hosting or application management services restrict our ability to sell our services in specified countries and to customers with revenue above or below specified revenue levels. For example, one agreement restricts us from selling our services to customers with annual revenues greater than $1 billion, and restricts our ability to sell to customers outside of North America. In addition, certain agreements contain limits on our ability to sell our services to certain types of customers. Our operating results and ability to grow could be harmed to the extent these licenses prohibit us from selling our services to customers to which we would otherwise sell our services, or in countries in which we would otherwise sell our services.

Poor performance of the software we deliver to our customers or disruptions in our business-critical services could harm our reputation, delay market acceptance of our services and subject us to liabilities.

Our customers depend on our hosted software applications for their critical systems and business functions, including enterprise resource planning, customer relationship management and e-commerce. Our customers' businesses could be seriously harmed if the applications we provide to them work improperly or fail, or if we have other service disruptions, even if only temporarily. Accordingly, if the software that we deliver to our customers or our implementation or ongoing management of such software performs poorly, experiences errors or defects or is otherwise unreliable, our customers would likely be extremely dissatisfied, which could cause our reputation to suffer, force us to divert research and development and management resources, cause a loss of revenues or hinder market acceptance of our services. It is also possible that any customer disruptions resulting from failures in our applications could force us to refund all or a portion of the fees customers have paid for our services or result in other significant liabilities to our customers.

We may fail to implement, host or manage enterprise software applications successfully due to the complicated nature of the services we provide, which would harm our reputation and sales.

Implementations and management of enterprise software applications are very complex. We cannot assure you that we can convince customers that we have the requisite expertise required to implement, host or manage these applications. Our reputation will be harmed and sales of our services would decline significantly if we are not able to complete successfully repeated implementations of our enterprise software applications or if we are not able to successfully manage enterprise applications, including those applications with which we have limited or no implementation, hosting or management experience to date.

Our inability to sufficiently expand our enterprise software implementation and systems consulting capabilities could harm our ability to service our customers effectively and could hinder our growth.

A failure to maintain and expand relationships with third party systems integrators that we use to implement our services could harm our ability to service our customers effectively. As we seek to provide applications management services for larger, more established customers, they may frequently utilize the systems integration and consulting services of independent, third party systems integrators rather than our services. In such cases, we may receive only modest revenue for implementation and integration services if any. For this reason and others, it may be difficult for us to maintain and increase our professional services revenues. In addition, we frequently contract with our customers for implementation on a fixed price basis. As a result, unexpected complexities in implementing software applications for our customers could result in unexpected losses for us or increases in losses. Our business and reputation could also be seriously harmed if third party systems integrators were unable to perform their services for our customers in a manner that meets customer expectations.

Increased demand for customization of our services beyond what we currently provide or anticipate could reduce the scalability and profitability of our business.

Companies may prefer more customized applications and services than our business model contemplates. Most of our customers have required some level of customization of our services, and our customers may continue to require customization in the future, perhaps to a greater extent than we currently provide or than is optimal. If we do not offer the desired customization, there may be less demand for our services. Conversely, providing customization of our services increases our costs and reduces our flexibility to provide similar services to many customers. Accordingly, increased demand for customization of our services could reduce the scalability and profitability of our business and increase risks associated with completing software upgrades.

A significant increase in our customer base could strain our operations and may result in our inability to properly manage our organizational structure.

Growth could strain our operations and require us to incur costs to purchase new infrastructure, upgrade our infrastructure and expand our personnel. If our customer base grows significantly, we cannot be sure that we will successfully manage our growth. In order to manage any such growth successfully, we must:

- expand our management team, financial and information systems and controls and operations team;
- maintain a high level of customer service and support;
- expand our implementation and consulting resources internally and with third parties;
- expand, train, manage and retain our employee base effectively; and
- manage costs for employees, hardware, software, data centers and networks in a manner that will permit our business to scale.

Any failure to effectively meet the above requirements could adversely affect our business. In addition, if our customer base grows significantly, there will be additional demands on our customer service support, research and development, sales and marketing and administrative resources as we try to increase our service offerings and expand our target markets. Any delay in the implementation of, or disruption in the transition to, new or enhanced systems and controls could harm our ability to accurately forecast demand for our services, manage our billing of customers, manage our sales cycle and implementation services and record and report management and financial information on a timely and accurate basis. Moreover, any inability to expand our service offerings and employee base commensurate with any increase in the demand for our services could cause our revenues to decline.

Our inability to successfully perform required software upgrades for our customers could cause interruptions or errors in our customers' applications, which could increase our costs and delay market acceptance of our services.

Our software vendors from time to time will upgrade their software applications, and at such time we may be required to implement these software upgrades for certain of our customers. Implementing software upgrades can be a complicated and costly process, particularly implementation of an upgrade simultaneously across multiple customers. Accordingly, we cannot assure you that we will be able to perform these upgrades successfully or at a reasonable cost. We may also experience difficulty implementing software upgrades to a large number of customers, particularly if different software vendors release upgrades simultaneously. If we are unable to perform software upgrades successfully and to a large customer base, our customers could be subject to increased risk of interruptions or errors in their business-critical software, our reputation and business would likely suffer and the market would likely delay the acceptance of our services. It will also be difficult for us to predict the timing of these upgrades, the cost to us and the additional resources that we may need to implement these upgrades. Additionally, as we continue to evolve our business model to charge customers for the cost of software upgrades, we may lose prospective customers who choose not to pay for these upgrades. Therefore, any such upgrades could strain our development and engineering resources, require significant unexpected expenses and cause us to miss our financial forecasts or those of securities analysts. Any of these problems could impair our customer relations and our reputation and subject us to litigation.

Security risks and concerns may decrease the demand for our services, and security breaches with respect to our systems may disrupt our services or make them inaccessible to our customers.

Our services involve the storage and transmission of business-critical, proprietary information, and security breaches could expose us to a risk of loss of this information, litigation and possible liability. Anyone who circumvents our security measures could misappropriate business-critical proprietary information or cause interruptions in our services or operations. In addition, computer "hackers" could introduce computer viruses into our systems or those of our customers, which could disrupt our services or make them inaccessible to customers. We may be required to expend significant capital and other resources to protect against the threat of security breaches or to alleviate problems caused by breaches. Our security measures may be inadequate to prevent security breaches, and our business and reputation would be harmed if we do not prevent them.

If we are unable to adapt our services to rapidly changing technology, our reputation and our ability to grow our revenues could be harmed.

The markets we serve are characterized by rapidly changing technology, evolving industry standards, emerging competition and the frequent introduction of new services, software and other products. We cannot assure you that we will be able to enhance existing or develop new services that meet changing customer needs in a timely and cost-effective manner. For example, as software application architecture changes, the software for which we provide services could become out of date or obsolete and we may be forced to upgrade or replace our technology. This is of particular concern with regard to our enterprise resource planning, or ERP, software, including PeopleSoft, Oracle and SAP. The architecture of the software we currently use for ERP applications is not designed to be hosted. We believe that future software may be written to be hosted. Our existing software application providers may face competition from new vendors who have written hostable software. It may be difficult for us to acquire hostable ERP software from these new vendors and for our software application providers to develop this software quickly or successfully. In either event, the services we offer would likely become less attractive to our customers, who could cause us to lose revenue and market share. Performing upgrades may also require substantial time and expense and even then we cannot be sure that we will succeed in adapting our business to these technological developments. Prolonged delays resulting from our efforts to adapt to rapid technological change, even if ultimately successful, could harm our reputation within our industry and our ability to grow our revenues.

Our application management agreements are typically long-term, fixed-price contracts, and if we are not able to manage our costs, these agreements may become unprofitable for us.

We enter into agreements with our customers to provide application management services for long periods, typically three years for our full service contracts. Most of these agreements are in the form of fixed-price contracts that do not provide for price adjustments to reflect any cost overruns associated with providing our services, such as potential increases in the costs of software applications we license from third parties, and the costs of upgrades or inflation or any other price increases in products or services supplied to us by third parties. As a result, unless we are able to provide our services in a more cost-effective manner than we do today and unless the number of users at individual customers increases to provide us higher revenue levels per customer, we may never achieve profitability for a particular customer. In addition, customers may not be able to pay us or may cancel our services before becoming profitable for us.

Our business is relatively new and, accordingly, our business and financial models may evolve as the understanding of our business evolves. We may be unable to adjust our pricing or cost structure with respect to our current customers in response to changes we make in our business or financial model due to the long-term, fixed price nature of the application management agreements we have with our customers. This potential inflexibility may hurt our ability to become profitable.

Downward pricing pressure may decrease our revenue.

Customers often request reductions in pricing upon contracts coming up for renewal and sometimes even prior to renewal. We have accommodated some of these requests in the past and may accommodate others in the future. As information technology services evolve we have noted that customers expect these services to be provided on a more efficient and cost-effective basis. We may not be able to increase efficiencies so as to maintain current profit margins on an individual customer basis, taking into account such reduced revenue. The downward pressure on pricing may result in decreased revenues and may make it difficult for us to become profitable.

Proposed changes to GAAP may require recording compensation expense for employee stock options.

The FASB and various legislative proposals have proposed changes to GAAP that may require us to adopt a different method of determining the compensation expense for our employee stock options. We currently use the intrinsic value method to measure compensation expense for stock-based awards to our employees. Under this standard, we generally do not consider stock option grants issued under our employee stock option plans to be compensation when the exercise price of the stock option is equal to the fair market value on the date of grant. If any change to GAAP is adopted that requires us to adopt a different method of determining the compensation expense for our employee stock options, our reported results of operations may be adversely affected.

We have focused on reducing costs, particularly in certain areas of our business, and these reductions may hinder sales and development of new technology.

In response to the difficult business environment and in order to try to bring our cost structure more in line with our revenues, we have been focusing on reducing our costs for some time. We have attempted to do this in a way that permits us to continue to provide excellent levels of service for customers, focusing on reducing costs by automating services, negotiating with vendors and headcount reductions in areas that have less direct impact on customers. We have significantly reduced our marketing expenses and this may adversely affect our ability to attract new customers and to increase our revenues. We have also significantly reduced our research and development expenses and this may adversely affect our ability to develop new technology, although we have attempted to augment our research and development capabilities through less expensive means such as through our Indian subsidiary.

If we do not meet the service levels we establish in our customer contracts, we may lose existing customers and revenue and our reputation and ability to engage potential customers may be adversely affected.

Our application management services contracts contain service level guarantees that obligate us to provide our applications at a guaranteed level of performance. If we fail to meet those service levels, we may be contractually obligated to provide our customers credit for free service. If we were to continue to fail to meet these service levels, our customers would then have the right to cancel their contracts with us. These credits or cancellations could harm our reputation and hinder our ability to grow our revenues.

If we cannot obtain additional software applications that meet the evolving business needs of our customers, the market for our services may not grow and may decline, and sales of our services may suffer.

Part of our strategy may be to expand our services by offering our customers services related to additional software applications that address their evolving business needs. Certain challenges may arise related to this potential strategy. For example, we cannot be sure that we will be able to license these applications at commercially viable rates or at all or otherwise be permitted access to the applications to provide our services, or, in the alternative, that we will be able to cost-effectively develop the applications in-house. If we cannot obtain these applications on a cost-effective basis or otherwise cannot effectively expand our service offering and, as a result, cannot expand the range of our service offerings, the market for our services may not grow and may decline, and sales of our services may suffer. Furthermore, we may not focus on the strategy of expanding by providing our services in relation to additional enterprise software applications, and this may be a strategic mistake.

We have many competitors and expect new competitors to enter our market, which could adversely affect our ability to increase revenues, maintain our margins or grow our market share.

The market for our services is extremely competitive and the barriers to entry in our market are relatively low. We currently have no patented technology that would bar competitors from our market.

Our current and potential competitors primarily include:

- application service providers and business process outsourcers, such as Affiliated Computer Systems, CSC, Electronic Data Systems, Hewlett-Packard, IBM Global Services, NaviSite and USinternetworking;

- systems integrators, such as Accenture and Bearing Point;

- offshore providers such as Wipro, Tata and Infosys;

- software vendors, such as Oracle, PeopleSoft, SAP, Ariba and Siebel Systems; and

- major technology providers, such as Microsoft.

Many of our competitors and potential competitors have substantially greater financial, customer support, technical and marketing resources, larger customer bases, longer operating histories, greater name recognition and more established relationships in the industry than we do. We cannot be sure that we will have the resources or expertise to compete successfully in the future. Our competitors may be able to:

- develop and expand their network infrastructures and service offerings more quickly;

- adapt to new or emerging technologies and changing customer needs faster;

- take advantage of acquisitions and other opportunities more readily;

- negotiate more favorable agreements with software application vendors;

- devote greater resources to the marketing and sale of their products; and

- address customers' service-related issues more effectively.

Some of our competitors may also be able to provide customers with additional benefits at lower overall costs or to reduce their application service charges aggressively in an effort to increase market share. We cannot be sure that we will be able to match cost reductions by our competitors.

Our competitors and other companies may form strategic relationships with each other to compete with us. These relationships may take the form of strategic investments, joint-marketing agreements, licenses or other contractual arrangements, which arrangements may increase our competitors' ability to address customer needs with their product and service offerings. We believe that there is likely to be consolidation in our markets, which could lead to increased price competition and other forms of competition that could cause our business to suffer.

We may lose customers or have to credit customers for our services if our network infrastructure is not delivered or serviced in a timely, consistent and cost-effective manner by third parties.

We depend on third parties, such as Qwest, AT&T, and (i)Structure, for our data center management services and for key components of our network infrastructure. Our contracts with these data center and network infrastructure providers are for a fixed term and for a specified amount of services, which may be insufficient to meet our needs. The services we provide could be materially disrupted by any disruption in the services provided by our data center management service providers. For example, downtime caused by our data center providers could materially disrupt our services, and, in the event any of these data center providers terminate or decline to renew their contracts with us, we could experience significant disruption and costs related to migrating customers to a different data center. We depend on suppliers such as Sun Microsystems for our computer hardware and WebMethods and Netegrity and others for our software technology platform. If any of these relationships fail to provide needed products or services in a timely and consistent manner or at an acceptable cost, we may be unable to deliver our services to our customers in an effective manner and these customers may terminate their contracts with us as a result or demand credits against fees. Some of the key components of our infrastructure are available only from sole or limited sources in the quantity and quality we demand. We do not carry significant inventories of those components that we obtain from third parties and have no guaranteed supply arrangements for some of these components. Additionally, some of our service and product providers have recently experienced financial difficulty, and financial problems they experience may cause disruptions in our service, loss of customers and expose us to additional costs.

Computer system failures could render us unable to service our customers and may cause us to lose our customers and subject us to liability and increased expenses.

Our operations depend upon our ability and the ability of our third party data center and network services providers to maintain and protect the computer systems on which we host our customers' applications. Any loss of customer data or an inability to provide service or service downtime for a period of time could cause us to lose our customers and subject us to significant potential liabilities. We currently use six data center providers to house our hardware and to provide network services, but most of our customers are serviced at a single site. While our data center and network providers maintain back-up systems and we have disaster recovery processes, a natural disaster or other disruption at their site could impair our ability to provide our services to our customers until the site is repaired or back-up systems become operable. Some of our data center providers, as well as our corporate headquarters, are located in Northern California, near known earthquake fault zones. Our systems and the data centers are also vulnerable to damage from fire, flood, power loss, telecommunications failures, terrorist attacks and similar events.

Our inability to retain and hire qualified and effective executive officers and critical personnel may adversely affect our ability to successfully manage our business or achieve our business objectives.

Our future success depends upon the continued service of our executive officers and other key personnel. None of our executive officers or key employees is bound by an employment agreement for any specific term. Key personnel may voluntarily terminate due to various reasons. If we lose the services of one or more of our executive officers or key employees, or if one or more of them decides to join a competitor or otherwise compete directly or indirectly with us, we may not be able to successfully manage our business or achieve our business objectives.

Our inability to retain and hire qualified and effective personnel may adversely affect our ability to grow our business.

In the future, we may expand our sales, operations and marketing efforts in order to try to increase market awareness and sales of our services. We may also need to increase our technical staff in order to service customers and perform research and development. There is competition for qualified and effective sales, marketing, technical and operations personnel as these personnel are in limited supply and in high demand and we might not be able to hire and retain sufficient numbers of these personnel to grow our business or to service our customers effectively. Also, past reductions in our workforce, although designed to not affect service levels and demand generation, may adversely affect these areas of our business.

Additionally, currently a substantial number of our employees are located in Balgalore, India at our subsidiary. Competition for employees in Bangalore is severe, and we may have difficulty retaining and recruiting qualified employees in Bangalore. Any such inability to retain and recruit such employees may result in a need for additional qualified employees and may result in increased costs to replace such employees.

In the event we are not able to achieve the anticipated benefits from our acquisition of Nexus this may increase our expenses without the expected increase in revenue, which will adversely affect our operating or financial results.

In October 2003 we acquired substantially all of the assets of Nexus as part of our efforts to expand our applications management business and product offerings. The rationale for the asset purchase was to expand our customer base and expertise in the SAP market space. SAP AG is a significant software vendor, providing enterprise resource planning and e-commerce software for businesses. We may experience difficulties in achieving and may never fully realize this anticipated benefit. Potential risks with this acquisition include, among others:

- possible impairment of relationships with employees and customers as a result of the acquisition of Nexus;
- inability to retain key employees of Nexus;
- inability to retain the SAP customers of Nexus;
- diversion of management's attention from other business concerns; and
- difficulties in assimilation of acquired personnel, operations, technologies or products.

In the event we are unable to retain Nexus's SAP customers or use this acquisition as a basis for expanding our customer base in the SAP market, or in the event the risks identified above lead to increased costs or a loss of benefits from the acquisition then we may never achieve the anticipated benefits of this acquisition and this will adversely impact our operating results. In addition, we have an obligation to issue additional shares of common stock to Nexus in the event we attain specified revenue milestones for the three month period ending December 31, 2004. Any such issuance would dilute our existing stockholders and increase the consideration we issue for the acquisition.

Any acquisitions of businesses, technologies or services may result in distraction of our management and disruptions to our business and additional costs.

In September 2002 and October 2003, we completed the acquisition of the ASP assets of Qwest Cyber Solutions LLC and Nexus, respectively. The integration of the ASP assets of Qwest Cyber Solutions and Nexus into our business is ongoing, and we may experience related disruptions and distractions as well as unexpected costs. We have lost, and may continue to lose, customers acquired from Qwest Cyber Solutions and Nexus.

We expect that further consolidation in our industry may occur. We may acquire or make investments in additional complementary businesses, technologies or services if appropriate opportunities arise. From time to time we may engage in discussions and negotiations with companies regarding acquiring or investing in their businesses, technologies or services. We cannot make assurances that we will be able to identify suitable acquisition or investment candidates, or that if we do identify suitable candidates, we will be able to make the acquisitions or investments on commercially acceptable terms or at all. If we acquire or invest in another company, we could have difficulty assimilating that company's personnel, customers, operations, technology or products and service offerings. In addition, the key personnel of the acquired company may decide not to work for us. These difficulties could disrupt our ongoing business, distract our management and employees, cause customer loss, increase our expenses and adversely affect our results of operations. Furthermore, we may incur indebtedness or issue equity securities to pay for any future acquisitions. The issuance of equity or convertible debt securities could be dilutive to our existing stockholders. Furthermore, any future acquisitions could materially deplete our cash.

Any inability to protect our intellectual property rights could reduce our competitive advantage, divert management's attention, and require additional intellectual property to be developed or cause us to incur expenses to enforce our rights.

We cannot assure you that we will be able to protect or maintain our intellectual property from infringement or misappropriation from others. In particular, our business would be harmed if we were unable to protect our technology platform and processes, our trademarks or our other software and confidential and proprietary information. Agreements on which we rely to protect our intellectual property rights and the trade secret, copyright and other laws on which we rely may only afford limited protection to these rights. We currently have no patents issued, which limits significantly our ability to protect our proprietary rights in the event they are infringed. Any infringement or misappropriation of our intellectual property could reduce our competitive advantage, divert management attention, require us to develop technology and cause us to incur expenses to enforce our rights.

Any infringement claims involving our technology or the applications we offer or other lawsuits could cost a significant amount of money and could divert management's attention away from our business.

If the number of software applications used by us and our customers increases and the functionality of these products further overlaps and integrates, software industry participants may become increasingly subject to infringement claims. In addition, we have agreed, and may agree in the future, to indemnify some of our customers against claims that our services infringe upon the intellectual property rights of others. Someone may claim that our technology or the applications or services we offer infringes their proprietary rights. Someone may also claim that we do not have adequate licenses to perform the services we offer. Any infringement claims, even if without merit, can be time consuming and expensive to defend, may divert management's attention and resources and could cause service delays. Such claims could require us to enter into costly royalty or licensing agreements. If successful, a claim of infringement against us and our inability to modify or license the infringed or similar technology could adversely affect our business. In addition, if our software vendors cease to offer their software applications to us because of infringement claims against them or us, we would be forced to license different software applications to our customers that may not meet our customers' needs. This could result in a loss of customers and a decline in our revenues.

In November 2001, a securities class action lawsuit was filed in the U.S. District Court for the Southern District of New York against us and certain of our officers and certain of the underwriters involved in our initial public offering. This is one of approximately 300 similar lawsuits in a coordinated proceeding sometimes referred to as "IPO allocation lawsuits" or "laddering lawsuits." The plaintiffs generally allege that the underwriters engaged in undisclosed improper practices by giving favorable allocations of IPO shares to certain investors in exchange for excessive brokerage commissions and/or agreements for those investors to purchase additional shares in the aftermarket at predetermined higher prices. The plaintiffs seek an unspecified amount of damages. In June 2003, the plaintiffs in these cases presented a settlement proposal to all of the issuer defendants. Under the proposed settlement, the plaintiffs proposed to dismiss and release all claims against participating defendants in exchange for a contingent payment guaranty by the insurance companies collectively responsible for insuring the issuers in all the related cases, and the assignment or surrender to the plaintiffs of certain claims the issuer defendants may have against the underwriters. Under the guaranty, the insurers or companies will be required to pay the amount, if any, by which $1 billion exceeds the aggregate amount ultimately collected by the plaintiffs from the underwriter defendants in all the cases. If the plaintiffs fail to recover $1 billion and payment is required under the guaranty, we would be responsible to pay our pro rata portion of the shortfall, up to the amount of the self-insured retention under its insurance policy, which is $1 million. In July 2003, we tentatively agreed to accept this settlement proposal. The settlement is subject to acceptance by a substantial majority of the issuer defendants and execution of a definitive settlement agreement. The settlement is also subject to approval by the Court, which cannot be assured, and the underwriters recently objected to the settlement. If the settlement is not accepted by the requisite number of defendants or if it is not approved by the Court or if it otherwise is not consummated, we intend to defend the lawsuit vigorously. However, the litigation is in the preliminary stage, and we cannot predict its outcome. The litigation process is inherently uncertain. If the outcome of the litigation were adverse to us and if we are required to pay significant monetary damages, our business would be significantly harmed. This lawsuit may be time consuming and expensive to defend and may divert management's attention and may be costly even if the plaintiff's settlement proposal is consummated.

Risks Related to our Industry

We cannot assure you that the ASP market will become viable or grow at a rate that will allow us to achieve profitability.

Growth in demand for and acceptance of ASPs and their hosted business software applications is highly uncertain. This is especially true given the uncertainty in the macroeconomic environment. Companies in the ASP industry, such as Pandesic and Red Gorilla and others, have ceased operations. Other companies in the ASP industry, such as USinternetworking, have filed for bankruptcy. We cannot assure you that this market will become viable or, if it becomes viable, that it will grow at a rate that will allow us to achieve profitability. The market for Internet services, private network management solutions and widely distributed Internet-enabled application software has only recently begun to develop and is now evolving rapidly. We believe that many of our potential customers are not fully aware of the benefits of hosted and managed solutions. It is possible that these solutions will never achieve market acceptance. It is also possible that potential customers will decide that the risks associated with hiring ASPs in general (or smaller service providers in particular) to implement and manage their critical systems and business functions outweigh the efficiencies associated with the products and services we provide. Concerns over transaction security and user privacy, inadequate network infrastructure for the entire Internet and inconsistent performance of the Internet and the financial viability of ASPs could also limit the growth of Internet-based business software solutions.

Increasing government regulation could limit the market for, or impose sales and other taxes on the sale of, our services, which could cause our revenues to decline or increase our expenses.

We offer our suite of software applications over networks, which subject us to government regulation concerning Internet usage and electronic commerce. We expect that state, federal and foreign agencies will adopt and modify regulations covering issues such as user and data privacy, pricing, taxation of goods and services provided over the Internet, the use and export of cryptographic technology and content and quality of products and services. It is possible that legislation could expose us and other companies involved in electronic commerce to liability or require permits or other authorizations, which could limit the growth of electronic commerce generally. Legislation could dampen the growth in Internet usage and decrease its acceptance as a communications and commercial medium. If enacted, these laws, rules or regulations could limit the market for or make it more difficult to offer our services.

The taxation of commerce activities in connection with the Internet has not been established, may change in the future and may vary from jurisdiction to jurisdiction. One or more states or countries may seek to impose sales or other taxes on companies that engage in or facilitate electronic commerce. A number of proposals have been made at the local, state, national and international levels that would impose additional taxes on the sale of products and services over the Internet. These proposals, if adopted, could substantially impair the growth of electronic commerce and could subject us to taxation relating to our use of the Internet as a means of delivering our services. Moreover, if any state or country were to assert successfully that we should collect sales or other taxes on the exchange of products and services over the Internet, our customers may refuse to continue using our services, which could cause our revenues to decline significantly.

If we expand our business outside the United States we may be subject to unfavorable international conditions and regulations that could cause our international business to fail.

We have customers with international operations, have established a subsidiary in India, and may expand our business outside of the United States in the future. Conducting our business in international markets is subject to complexities associated with foreign operations and to additional risks related to our business, including the possibility that the scarcity of cost-effective, high-speed Internet access and the slow pace of future improvements in access to the Internet will limit the market for hosting software applications over the Internet or adversely affect the delivery of our services to customers. Additionally, some countries outside of the United States do not permit hosting applications on behalf of companies. The European Union has adopted a privacy directive that regulates the collection and use of information. This directive may inhibit or prohibit the collection and sharing of personal information in ways that could harm us. The globalization of Internet commerce may be harmed by these and similar regulations since the European Union privacy directive prohibits transmission of personal information outside the European Union unless the receiving country has enacted individual privacy protection laws at least as strong as those enacted by the European Union privacy directive.

General political and economic conditions may reduce our revenues and harm our operations.

Because of the economic and political environment, many industries have delayed or reduced technology expenditures. If this trend continues, we may fall short of our revenue expectations, and ultimately may fail to achieve profitability. Additionally, weakness in the technology sector as a whole could negatively affect the cash flow of some of our customers, which in turn could impact their ability to meet their obligations to us as they come due. This could increase our credit risk exposure and harm our overall financial position.

In addition, global and domestic political conditions, terrorist acts, or acts of war (wherever located in the world) may damage or disrupt global and domestic markets and negatively affect our business, employees, customers, and suppliers, which in turn could have an adverse effect on our operations and our overall profitability.

Market prices of Internet and technology companies have been highly volatile, and the market for our stock may be volatile as well.

The stock market has experienced significant price and trading volume fluctuations, and the market prices of technology companies generally, and Internet-related software companies particularly, have been volatile. The market prices of technology companies generally, and technology service companies in particular, have been subject to significant downward pressure. In the past, following periods of volatility in the market price of a public company's securities, securities class action litigation has often been instituted against that company. Such litigation could result in substantial costs to us and a diversion of our management's attention and resources.

Many significant corporate actions are controlled by our officers, directors and affiliated entities regardless of the opposition of other investors or the desire of other investors to pursue an alternative cause of action.

Our executive officers, directors and entities affiliated with them, in the aggregate, beneficially own approximately 40% of our common stock as of September 30, 2004. If they were to act together, these stockholders would be able to exercise control over most matters requiring approval by our stockholders, including the election of directors and approval of significant corporate transactions. This concentration of ownership may also have the effect of delaying or preventing a change in control of our company, which could cause our stock price to drop. These actions may be taken even if they are opposed by the other investors, including those who purchased shares in the initial public offering.

Delaware law and our charter, bylaws and contracts provide anti-takeover defenses that could delay or prevent an acquisition of us, even if an acquisition would be beneficial to our stockholders.

Provisions of Delaware law, our certificate of incorporation, bylaws and contracts could delay, defer or prevent an acquisition or change of control of us, even if an acquisition would be beneficial to our stockholders, and this could adversely affect the price of our common stock.

- Our bylaws limit the ability of our stockholders to call a special meeting and do not permit stockholders to act by written consent.

- We are subject to the anti-takeover provisions of Section 203 of the Delaware General Corporation Law, which prohibits us from engaging in a "business combination" with an "interested stockholder" for a period of three years after the date of the transaction in which the person became an interested stockholder, unless the business combination is approved in a prescribed manner.

- Several members of our senior management have contracts with us that provide for the acceleration of the vesting of their stock options upon termination following a change of control, and members of our board of directors have contracts with us that provide for the acceleration of vesting of their stock options upon a change of control.

- Our certificate of incorporation permits our board to issue shares of preferred stock without stockholder approval. In addition to delaying or preventing an acquisition, the issuance of a substantial number of shares of preferred stock could adversely affect the price of the common stock.

Additional provisions of our certificate of incorporation that may serve to delay or prevent an acquisition include a staggered board, advance notice procedures for stockholders to nominate candidates for election as directors, authorization of our board to alter the number of directors without stockholder approval and lack of cumulative voting.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

We develop and market our services primarily in the United States. As we expand our operations outside of the United States, our financial results could be affected by factors such as changes in foreign currency rates or weak economic conditions in foreign markets. Because all of our revenues are currently denominated in U.S. dollars, a strengthening of the dollar could make our services less competitive in international markets.

Interest Rate Risk

The primary objective of our investment activities is to preserve principal while at the same time maximize the income we receive from our investments without significantly increasing risk. Some of the securities that we have invested in may be subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. For example, if we hold a security that was issued with a fixed interest rate at the then-prevailing interest rate and the prevailing interest rate later rises, the fair value amount of our investment will probably decline. To minimize this risk, we maintain our portfolio of cash equivalents and short-term investments in a variety of securities, including Government Securities, Commercial Paper, Corporate Bonds and money market funds. In general, money market funds are not subject to market risk because the interest paid on such funds fluctuates with the prevailing interest rate. The following table presents the amounts of our cash equivalents and short-term investments that are subject to market risk by range of expected maturity and weighted-average interest rates as of September 30, 2004.

September 30, 2004 (in thousands, except percentages):		Maturing in Three months or less		Maturing Between Three months and Thirteen months
Included in cash and cash equivalents	$	3,095	$	--
Weighted-average interest rate		1.80 %		--
Included in short-term investments	$	2,509	$	18,334
Weighted-average interest rate		1.50 %		1.80 %

ITEM 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures.

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that, except as discussed below with respect to absence of appropriate levels of accounting personnel, our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

(b) Changes in internal controls.

As discussed in our Current Report on Form 8-K filed with the Securities and Exchange Commission on August 4, 2004, KPMG noted deficiencies related to our internal controls around monitoring of debt covenant compliance, the absence of appropriate levels of accounting personnel, the absence of appropriate review and approval of manual journal entries, and evidence of failure to reconcile bank statements in a timely manner. We believe that we have remedied all of these deficiencies except the absence of the appropriate levels of accounting personnel, which we expect to remedy soon, as discussed below.

- Monitoring debt covenant compliance. This finding relates to a new debt arrangement entered into in March 2004 with Wells Fargo Bank. We have clarified the covenants with Wells Fargo Bank and reemphasized monitoring of the compliance of these covenants as part of our monthly close process.

- Absence of appropriate levels of accounting personnel. At the time KPMG noted this deficiency, five members of our finance and accounting departments were temporary consultants. Since that time, we have hired as full time employees four of the positions previously staffed by the five temporary consultants. In addition, we have hired an incremental accounting headcount and we are in the process of performing a search for an additional incremental permanent accounting position in the near future.

- Absence of appropriate review and approval of manual journal entries. We have reemphasized the requirement to properly document the review of all manual journal entries. As an additional control, we have added a second review to confirm that the review of all manual entries has been properly documented.

- Evidence of failure to reconcile bank statements in a timely manner. Our accounting manager was called up for three weeks of United States military service during our accounting close process for the quarterly period ended June 30, 2004, and therefore did not complete some of our bank reconciliations as part of our normal quarterly closing process. These reconciliations were completed in time for our second quarter 2004 earning release by other accounting department personnel. Again, we have reemphasized the company policy regarding the timely completion of all reconciliations.

In late 2003, we started preliminary efforts to analyze our system of internal controls over financial reporting, and in response to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, beginning in mid-2004, we have invested significant resources in documenting and improving these controls. In the course of our compliance activities, we have identified areas of our internal controls for specific improvement, including management of our inventory of fixed assets, our billing processes and systems, internal access policies to certain data systems, and coordination across our different business functions. We continue to design and implement enhanced processes and controls to address these and other of our internal controls in preparation for our first management report on internal controls over financial reporting, as required by Section 404, as of December 31, 2004. In connection with our continuing compliance efforts, we have made and expect to continue to make changes in our internal controls.

Except as stated above, there was no change in our internal controls over financial reporting during the period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In November 2001, a securities class action lawsuit was filed in the U.S. District Court for the Southern District of New York against us and certain of our officers and certain of the underwriters involved in our initial public offering. This is one of approximately 300 similar lawsuits in a coordinated proceeding sometimes referred to as “IPO allocation lawsuits” or “laddering lawsuits.” The plaintiffs generally allege that the underwriters engaged in undisclosed improper practices by giving favorable allocations of IPO shares to certain investors in exchange for excessive brokerage commissions and/or agreements for those investors to purchase additional shares in the aftermarket at predetermined higher prices. The plaintiffs seek an unspecified amount of damages. In June 2003, the plaintiffs in these cases presented a settlement proposal to all of the issuer defendants. Under the proposed settlement, the plaintiffs proposed to dismiss and release all claims against participating defendants in exchange for a contingent payment guaranty by the insurance companies collectively responsible for insuring the issuers in all the related cases, and the assignment or surrender to the plaintiffs of certain claims the issuer defendants may have against the underwriters. Under the guaranty, the insurers or companies will be required to pay the amount, if any, by which $1 billion exceeds the aggregate amount ultimately collected by the plaintiffs from the underwriter defendants in all the cases. If the plaintiffs fail to recover $1 billion and payment is required under the guaranty, we would be responsible to pay its pro rata portion of the shortfall, up to the amount of the self-insured retention under its insurance policy, which is $1 million. In July 2003, we tentatively agreed to accept this settlement proposal. The settlement is subject to acceptance by a substantial majority of the issuer defendants and execution of a definitive settlement agreement. The settlement is also subject to approval by the Court, which cannot be assured, and the underwriters recently objected to the settlement. If the settlement is not accepted by the requisite number of defendants or if it is not approved by the Court or if it otherwise is not consummated, we intend to defend the lawsuit vigorously. However, the litigation is in the preliminary stage, and we cannot predict its outcome. The litigation process is inherently uncertain. If the outcome of the litigation were adverse to us and if we are required to pay significant monetary damages, our business would be significantly harmed. This lawsuit may be time consuming and expensive to defend and may divert management’s attention and may be costly to Corio even if the plaintiff’s settlement proposal is consummated.

In November 2001, Corio filed a demand for arbitration against LivePerson, Inc. with the American Arbitration Association in San Francisco County. The arbitration related to a dispute around a services contract between the parties. On July 23, 2003, the arbitrator in this dispute issued a judgment awarding Corio damages of $1,115,440 plus interest. LivePerson, Inc. filed a motion to vacate the award in the Superior Court of California. On November 18, 2003, the Superior Court of California issued a judgment, relating to the arbitration, awarding Corio damages of $1,346,605 plus interest from October 17, 2003 until the date of payment. LivePerson, Inc. paid Corio $1,369,479 on December 18, 2003 and subsequently appealed the judgment. On October 8, 2004, the Appellate Court of California affirmed the judgment of the Superior Court of California in favor of Corio. For any portion of the cash paid that is determined by the Company as revenue that should be recorded under the Company’s revenue recognition policy, such cash received pursuant to this award will be recorded as termination fee revenue at that time. The Company recorded the amount received as an accrued liability.

The Company is subject to other legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, management does not expect that the ultimate costs to resolve these other matters will have a material adverse effect on the Company’s financial statements.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Not applicable

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable

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

Not applicable

ITEM 5. OTHER INFORMATION

Not applicable

ITEM 6. EXHIBITS

10.19	The Second Amendment to Credit Agreement entered into as of September 30, 2004, by and between Corio, Inc., a Delaware Corporation and Wells Fargo Bank, National Association
10.20	Termination Settlement Agreement entered into as of September 29, 2004, by and between Corio, Inc., a Delaware Corporation and Avaya, Inc.
10.21	Amendment of Change in Control Agreement entered into as of October 4, 2004 by and between the Registrant and Arthur Chiang, Senior Vice President, Corporate Development and Investor Relations
10.22	Amendment of Change in Control Agreement entered into as of October 4, 2004 by and between the Registrant and Brett White, Executive Vice President, Chief Financial Officer
10.23	Amendment of Change in Control Agreement entered into as of October 4, 2004 by and between the Registrant and Sal Jamil, Executive Vice President, Chief Operating Officer
10.24	Amendment of Change in Control Agreement entered into as of October 4, 2004 by and between the Registrant and John Ottman, Executive Vice President, Worldwide Markets
10.25	Employment Agreement entered into as of June 11, 1999 by and between the Registrant and George Kadifa, Chairman of the Board and Chief Executive Officer
10.26	Amendment to Employment Agreement entered into as of July 15, 2004 by and between the Registrant and George Kadifa, Chairman of the Board and Chief Executive Officer
10.27	Amendment of Change in Control Agreement entered into as of April 15, 2001 by and between the Registrant and George Kadifa, Chairman of the Board and Chief Executive Officer
10.28	Amendment of Change in Control Agreement entered into as of October 4, 2004 by and between the Registrant and George Kadifa, Chairman of the Board and Chief Executive Officer
10.29	Corio Inc.'s Stock Option Agreement Form
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32.1	Section 906 Certification of Chief Executive Officer
32.2	Section 906 Certification of Chief Financial Officer

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.

Dated: November 12, 2004

CORIO, INC.

By: /s/ GEORGE KADIFA
George Kadifa
President and Chief Executive Officer

By: /s/ BRETT WHITE
Brett White
Executive Vice President and
Chief Financial Officer

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