

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended July 31, 2003**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 000-31989**

**CONVERA CORPORATION**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**54-1987541**

(I.R.S. Employer  
Identification No.)

**1921 Gallows Road, Suite 200, Vienna, Virginia**  
(Address of principal executive offices)

**22182**  
(Zip Code)

Registrant's telephone number, including area code: **(703) 761 - 3700**

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 the filing requirements for the past 90 days.

Yes ☒ No ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2.)

Yes ☐ No ☒

The number of shares outstanding of the registrant's Class A common stock as of September 5, 2003 was 33,798,971.

**CONVERA CORPORATION**  
**QUARTERLY REPORT ON FORM 10-Q**  
**FOR THE QUARTER ENDED JULY 31, 2003**

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**CONVERA CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)

ASSETS	July 31, 2003 (Unaudited)	January 31, 2003
Current Assets:		
Cash and cash equivalents.....	\$ 31,227	\$ 10,318
Short term investments.....	5,355	20,148
Accounts receivable, net of allowance for doubtful accounts of \$1,713 and \$1,569, respectively .....	7,287	6,732
Prepaid expenses and other .....	3,164	2,509
Total current assets .....	47,033	39,707
Equipment and leasehold improvements, net of accumulated depreciation of \$11,705 and \$10,843, respectively.....	2,228	2,906
Other assets.....	2,874	3,154
Goodwill and other intangible assets.....	3,245	3,372
Total assets .....	<u>\$ 55,380</u>	<u>\$ 49,139</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable .....	\$ 3,452	\$ 3,069
Accrued expenses.....	7,309	7,220
Accrued bonuses .....	1,125	919
Restructuring reserve.....	884	1,326
Deferred revenues .....	3,423	2,739
Total current liabilities.....	16,193	15,273
Restructuring reserve, net of current portion.....	1,204	1,494
Total liabilities .....	<u>17,397</u>	<u>16,767</u>
Commitments and Contingencies		
Shareholders' Equity:		
Common stock Class A, \$0.01 par value, 100,000,000 shares authorized; 34,614,389 and 29,880,217 shares issued, respectively; 33,778,842 and 29,003,062 shares outstanding, respectively .....	346	299
Treasury stock at cost, 835,547 and 877,155 shares, respectively .....	(1,930)	(2,026)
Additional paid-in capital .....	1,070,071	1,053,455
Accumulated deficit .....	(1,029,581)	(1,018,540)
Accumulated other comprehensive loss .....	(923)	(816)
Total shareholders' equity.....	37,983	32,372
Total liabilities and shareholders' equity .....	<u>\$ 55,380</u>	<u>\$ 49,139</u>

See accompanying notes.

**CONVERA CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS**

(unaudited)  
(in thousands, except share and per share data)

	Three Months Ended July 31,		Six Months Ended July 31,	
	2003	2002	2003	2002
Revenues:				
License.....	\$ 4,587	\$ 2,376	\$ 8,818	\$ 5,986
Professional services.....	1,467	982	2,666	1,945
Maintenance .....	1,559	1,678	3,089	3,398
	<u>7,613</u>	<u>5,036</u>	<u>14,573</u>	<u>11,329</u>
Cost of revenues:				
License.....	\$ 454	\$ 697	\$ 817	\$ 1,451
Professional services.....	1,375	1,393	2,792	3,209
Maintenance .....	503	444	966	947
	<u>2,332</u>	<u>2,534</u>	<u>4,575</u>	<u>5,607</u>
Gross margin:	<u>5,281</u>	<u>2,502</u>	<u>9,998</u>	<u>5,722</u>
Operating expenses:				
Sales and marketing .....	4,634	5,162	9,333	11,547
Research and product development.....	3,219	3,003	6,500	6,263
General and administrative.....	2,233	2,381	4,524	4,918
Restructuring charges.....	295	1,043	621	1,890
Incentive bonus payments due to employees	-	-	-	(138)
Amortization of intangible assets .....	67	67	135	107
Acquired in-process research and development .....	-	-	-	126
	<u>10,448</u>	<u>11,656</u>	<u>21,113</u>	<u>24,713</u>
Operating loss.....	<u>(5,167)</u>	<u>(9,154)</u>	<u>(11,115)</u>	<u>(18,991)</u>
Interest income, net .....	<u>50</u>	<u>159</u>	<u>101</u>	<u>387</u>
Net loss.....	<u>\$ (5,117)</u>	<u>\$ (8,995)</u>	<u>\$ (11,014)</u>	<u>\$ (18,604)</u>
Basic and diluted net loss per common share ...	\$ (0.18)	\$ (0.31)	\$ (0.38)	\$ (0.65)
Weighted-average number of common shares outstanding – basic and diluted .....	29,209,859	28,912,832	29,122,798	28,722,805
Other comprehensive loss:				
Net loss.....	\$ (5,117)	\$ (8,995)	\$ (11,014)	\$ (18,604)
Foreign currency translation adjustment .....	136	289	(107)	28
Comprehensive loss.....	<u>\$ (4,981)</u>	<u>\$ (8,706)</u>	<u>\$ (11,121)</u>	<u>\$ (18,576)</u>

See accompanying notes.

**CONVERA CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited)  
(in thousands)

	For the Six Months Ended July 31, 2003	2002
Cash Flows from Operating Activities:		
Net loss.....	\$ (11,014)	\$ (18,604)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation.....	868	1,211
Provision for doubtful accounts.....	200	200
Amortization of intangible assets .....	135	107
Acquired in-process research and development .....	-	126
Amortization of deferred stock compensation .....	171	-
Changes in operating assets and liabilities, net of effects from acquisition:		
Accounts receivable.....	(837)	1,872
Prepaid expenses and other assets .....	(24)	2,311
Accounts payable, accrued expenses and accrued bonuses .....	691	(1,571)
Restructuring reserve .....	(732)	(231)
Deferred revenues.....	701	(775)
Net cash used in operating activities .....	<u>(9,841)</u>	<u>(15,354)</u>
Cash Flows from Investing Activities:		
Proceeds from maturities of investments, net.....	14,803	19,705
Purchases of equipment and leasehold improvements .....	(190)	(554)
Acquisition of business, net of cash acquired .....	-	129
Net cash provided by investing activities .....	<u>14,613</u>	<u>19,280</u>
Cash Flows from Financing Activities:		
Proceeds from the private placement of common stock, net...	16,032	-
Proceeds from the issuance of common stock, net.....	78	114
Proceeds from the exercise of stock options .....	83	14
Net cash provided by financing activities .....	<u>16,193</u>	<u>128</u>
Effect of Exchange Rate Changes on Cash .....	<u>(56)</u>	<u>(420)</u>
Net Increase in Cash and Cash Equivalents .....	20,909	3,634
Cash and Cash Equivalents, beginning of period .....	10,318	17,628
Cash and Cash Equivalents, end of period .....	<u>\$ 31,227</u>	<u>\$ 21,262</u>

See accompanying notes.

## **CONVERA CORPORATION AND SUBSIDIARIES**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **(1) THE COMPANY**

Convera Corporation (“Convera” or the “Company”) principally earns revenues from the licensing of its software products and the provision of services in deployment of the Company’s technology to commercial businesses and government agencies throughout North America, Europe and other parts of the world. The Company licenses its software to end users directly and also distributes its software products through license agreements with system integrators, original equipment manufacturers, value-added resellers and other strategic partners. Revenues are generated from software licenses with customers and from the related sale of product maintenance, training and implementation support services.

The Company’s operations are subject to certain risks and uncertainties including, but not limited to: the dependence upon the timing of the closing on sales of software licenses; the effect of general economic conditions on demand for the Company’s products and services, including reduced corporate IT spending and lengthier sales cycles; actual and potential competition by entities with greater financial resources, experience and market presence than the Company; rapid technological changes; the success of the Company’s product marketing and product distribution strategies; changes in the nature or timing of the product development plan as determined by the Company; the risks associated with acquisitions and international expansion; the need to manage growth; the need to retain key personnel and protect intellectual property; possible disruption in commercial activities caused by terrorist activity and armed conflict, such as changes in logistics and security arrangements; and the availability of additional capital financing on terms acceptable to the Company.

As of July 31, 2003, Allen Holding, Inc., together with Allen & Company Incorporated, Herbert A. Allen and certain related parties (collectively “Allen & Company”) beneficially own more than 50% of the voting power of Convera.

#### **(2) SIGNIFICANT ACCOUNTING POLICIES**

##### **Financial Statement Presentation**

These consolidated financial statements are unaudited and have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. It is suggested that these consolidated financial statements be read in conjunction with the consolidated financial statements, and the notes thereto, included in the Company's Annual Report on Form 10-K for the fiscal year ended January 31, 2003. In the opinion of management, the consolidated financial statements for the fiscal periods presented herein include all normal and recurring adjustments that are necessary for a fair presentation of the results for these interim periods. The results of operations for the three- and six-month periods ended July 31, 2003 are not necessarily indicative of the results for the entire fiscal year ending January 31, 2004.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

##### **Principles of consolidation**

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

## **Revenue Recognition**

The Company recognizes revenue in accordance with American Institute of Certified Public Accountants' Statement of Position 97-2, Software Revenue Recognition ("SOP 97-2"), as amended by Statement of Position 98-9, Software Revenue Recognition, with respect to certain transactions.

Revenue from the sale of software licenses is recognized upon shipment of product, provided that the fee is fixed and determinable, persuasive evidence of an arrangement exists and collection of the resulting receivable is considered probable. Historically, the Company has not experienced significant returns or exchanges of its products.

Revenue from training and systems implementation services is recognized when the services are performed. Such services are sold as part of a bundled software license agreement as well as separately to customers who have previously purchased software licenses. When training or systems implementation services that are not essential to the functionality of the software are sold as part of a bundled license agreement, the fair value of these services, based on the price charged for the services when sold separately, is deferred and recognized when the services are performed.

Customization work is sometimes required to ensure that the Company's software functionality meets the requirements of its customers. Under these circumstances, the Company's revenues are derived from fixed price contracts and revenue is recognized using the percentage of completion method based on the relationship of actual costs incurred to total costs estimated over the duration of the contract. Estimated losses on such contracts are charged against earnings in the period such losses are identified.

Maintenance revenue related to customer support agreements is deferred and recognized ratably over the term of the respective agreements. Customer support agreements generally include bug fixes, telephone support and product release upgrades on a when and if available basis. When the Company provides a software license and the related customer support arrangement for one bundled price, the fair value of the customer support, based on the price charged for that element when sold separately, is deferred and recognized ratably over the term of the respective agreement.

The Company incurs shipping and handling costs, which are recorded in cost of license revenues.

## **Stock-Based Compensation**

SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"), allows companies to account for stock-based compensation either under the provisions of SFAS No. 123 or under the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), as amended by FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation (an interpretation of APB Opinion No. 25)." The Company has elected to account for its stock-based compensation in accordance with the provisions of APB 25. Stock options granted under the Company's stock option plans had an exercise price equal to the market value of the underlying common stock on the date of grant, and accordingly no employee compensation cost related to the options has been included in expenses. Nonvested shares of stock (referred to as deferred stock) granted under the Company's stock option plan are measured at fair value on the date of grant based on the number of shares granted and the quoted price of the Company's common stock. Such value is recognized as compensation expense over the corresponding service period.

Had compensation cost for all of the Company's stock-based compensation been determined based on the fair value at the grant dates for awards made under the stock option and purchase plans as set forth in SFAS No. 123, the Company's net loss and basic and diluted net loss per common share would have been increased to the pro forma amounts indicated below (in thousands, except per share data).

	Three Months Ended July 31,		Six Months Ended July 31,	
	2003	2002	2003	2002
Net loss, as reported	\$ (5,117)	\$ (8,995)	\$ (11,014)	\$ (18,604)
Stock-based compensation, as reported	171	-	171	-
Total stock-based compensation determined under fair value based method for all awards	<u>(1,779)</u>	<u>(1,825)</u>	<u>(3,384)</u>	<u>(4,626)</u>
Pro forma net loss	\$ <u>(6,725)</u>	\$ <u>(10,820)</u>	\$ <u>(14,227)</u>	\$ <u>(23,230)</u>
Basic and diluted net loss per common share, as reported	(\$0.18)	(\$0.31)	(\$0.38)	(\$0.65)
Basic and diluted net loss per common share, pro forma	(\$0.23)	(\$0.37)	(\$0.49)	(\$0.81)

The fair value of each option is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions used for option grants under the Company's stock option plans issued during the three and six months ended July 31, 2003 and 2002, respectively: volatility factors of 96% and 95%, risk-free interest rates of 2.8% and 4.4%, weighted-average expected life of 5 years, and no dividend yields.

The following assumptions were used for shares issued during the six months ended July 31, 2003 and 2002, respectively, under the Company's employee stock purchase plan: volatility factors of 96% and 95%, risk free interest rates of 1.1% and 1.8%, weighted-average expected life of 3 months, and no dividend yields.

The weighted average fair value of stock options granted under the Company's stock option plans during the three months ended July 31, 2003 and 2002 were \$3.25 and \$2.85, respectively, and during the six months ended July 31, 2003 and 2002 were \$3.00 and \$2.86, respectively.

On May 20, 2003 pursuant to the Company's 2000 Stock Option Plan, two executive officers of the Company were awarded an aggregate of one million shares of deferred stock with a five-year cliff vesting provision. The deferred stock vests immediately if the holder is terminated without cause or if there is a change in control. These awards were valued at \$4,370,000, based on the market price of the Company's stock on the date of award. Compensation cost will be expensed on a straight-line basis over the five-year vesting period. For the quarter ended July 31, 2003, the Company recorded compensation expense of \$171,000 in connection with these awards.

In the first quarter of the current fiscal year, the Company issued two-year warrants to purchase 137,711 shares of Convera common stock to a third party customer at an exercise price of \$2.00 per share. The warrants had an aggregate value of approximately \$380,000 using the Black-Scholes option-pricing model with the following assumptions: expected volatility of 108%; risk free interest rate of 2.12%; no dividend yield; and expected life of 2 years. The value of the warrants was recorded as an offset against revenue and an increase to additional paid-in-capital during the first quarter.

### **(3) RECENT PRONOUNCEMENTS**

In July 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (“SFAS”) 146, “Accounting for Costs Associated with Exit or Disposal Activities.” SFAS No. 146 requires that a liability for the costs associated with exit or disposal activities be recognized and measured initially at fair value when the liability is incurred rather than the date the Company commits to a disposal plan. SFAS No. 146 was effective for all exit or disposal activities initiated after December 31, 2002. The Company has adopted SFAS No. 146, and such adoption was not significant to the Company’s July 31, 2003 financial statements. The principal effect of applying FAS No. 146 will be on the timing of cost recognition of any such disposal activities.

In December 2002, the FASB issued SFAS No. 148, “Accounting for Stock-Based Compensation - Transition and Disclosure.” SFAS No. 148 amends SFAS No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair-value for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS No. 148 was effective for fiscal years ending after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. The Company has adopted SFAS No. 148, and such adoption did not have any effect on the Company’s financial position and results of operations.

In January 2003, the FASB issued FASB Interpretation No. 46 (“FIN 46”), “Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51.” FIN No. 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN No. 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN No. 46 must be applied for the first interim or annual period beginning after June 15, 2003. The Company does not have any controlling interest, contractual relationships or other business relationships with variable interest entities and therefore the adoption of this standard did not have any effect on the Company’s financial position and results of operations.

### **(4) ISSUANCE OF COMMON STOCK**

On July 30, 2003, the Company completed a private placement of 4,714,111 shares (the “Shares”) of its common stock to a group of unaffiliated institutional investors. The Company sold the Shares at a purchase price of \$3.60 per share, resulting in proceeds to the Company of approximately \$17 million. In connection with this private placement, the Company incurred expenses of approximately \$940,000, which have been recorded in equity as an offset against the proceeds. The Company plans to use the net proceeds to finance ongoing operations and for general corporate purposes, including potential acquisitions. Allen & Company LLC, a company controlled by the majority shareholder, acted as placement agent for the private placement and was paid a commission of 5%, which is included in the offering expenses above.

### **(5) NET LOSS PER COMMON SHARE**

The Company follows Financial Accounting Standards Board Statement No. 128, “Earnings Per Share,” (“SFAS 128”) for computing and presenting net loss per share information. Basic loss per common share is computed by dividing net loss available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted loss per common share excludes common equivalent shares, including deferred stock awards and unexercised stock options and warrants, as their inclusion in the computation would be anti-dilutive.

The following table sets forth the computation of basic and diluted net loss per common share (in thousands, except share and per share data):

	Three Months Ended July 31,		Six Months Ended July 31,	
	2003	2002	2003	2002
Numerator:				
Net loss.....	\$ (5,117)	\$ (8,995)	\$ (11,014)	\$ (18,604)
Denominator:				
Weighted average number of common shares outstanding – basic and diluted .....	29,209,859	28,912,832	29,122,798	28,722,805
Basic and diluted net loss per common share .....	\$ (0.18)	\$ (0.31)	\$ (0.38)	\$ (0.65)

Using the treasury stock method, the following equity instruments were not included in the computation of diluted net loss per common share because their effect would be anti-dilutive:

	Three Months Ended July 31,		Six Months Ended July 31,	
	2003	2002	2003	2002
Stock options.....	357,683	11,938	186,138	18,932
Deferred stock .....	40,809	-	-	-
Warrants.....	75,539	-	70,877	-
	<u>474,031</u>	<u>11,938</u>	<u>257,015</u>	<u>18,932</u>

## (6) ACQUISITION

On March 7, 2002, the Company acquired 100% of the outstanding capital stock of Semantix Inc., a private Canadian software company specializing in cross-lingual processing and computational linguistics technology, for 900,000 shares of restricted Convera common stock and approximately \$24,000 in cash. Semantix Inc. became a wholly owned subsidiary of Convera under the name Convera Canada, Inc. This acquisition broadened the linguistic capabilities of the Convera RetrievalWare® search and retrieval technology, specifically in the areas of cross-lingual search and the continued development of language capabilities to support the needs of specialized vertical markets. It also enabled the Company to derive greater revenues through the direct sales of language modules to new and existing customers.

This acquisition has been accounted for using the purchase method of accounting, and the results of operations of Convera Canada, Inc. have been included in the Company's consolidated statements of operations from the date of acquisition. The purchase price was determined to be approximately \$4,403,000, which included liabilities assumed of approximately \$748,000 and approximately \$224,000 of transaction and direct acquisition costs. The shares issued to Semantix Inc. as consideration were valued based on the average market price of Convera stock from March 5, 2002 through March 11, 2002, or two business days before and after the date the terms of the acquisition were agreed to and announced, which was March 7, 2002. The purchase price was allocated to the assets acquired based on their estimated fair values on the acquisition date as follows (in thousands):

Tangible assets acquired	\$ 663
Developed technology	1,346
Acquired in-process research and development	126
Goodwill	<u>2,268</u>
Total purchase price	<u>\$ 4,403</u>

Developed technology is being amortized on a straight-line basis over five years. To determine the fair market value of the developed technology, the Company used the relief from royalty method, which uses the amount of royalty expense the Company would have incurred if the developed technology were licensed in an arms length transaction instead of purchased. The acquired in-process research and development ("IPRD") of \$126,000 was expensed immediately since the related technology had not reached technological feasibility as of the date of the acquisition. To determine the value of the IPRD, the discounted cash flow method, which entails a projection of the prospective cash flows to be generated from the sale of the technology over a discrete period of time, discounted at a rate in order to calculate present value, was used. The remainder of the purchase price minus the tangible assets acquired and the intangible assets created was allocated to goodwill. Goodwill is not being amortized but is reviewed at least annually for impairment in accordance with SFAS No. 142. There was no impairment of goodwill recorded for the quarter ended July 31, 2003.

## **(7) RESTRUCTURINGS**

During the first quarter of the current fiscal year, the Company adopted a restructuring plan in its continued effort to streamline operations. In connection with this reorganization, the Company reduced its workforce by 11 employees worldwide, including four individuals from the G&A group, four from the marketing group, two from the sales group and one from the engineering group. The Company recorded a restructuring charge of \$325,000 related to severance costs for terminated employees.

In the current quarter ended July 31, 2003, the Company announced an additional reduction in force. As a result of this action, the Company reduced its workforce by 17 employees worldwide, including nine individuals from the engineering group, three from the sales group, three from the professional services group and two from the marketing group. The Company recorded a restructuring charge of \$295,000 related to severance costs for terminated employees.

During the previous fiscal year, the Company had adopted restructuring plans in its continued effort to align its sales efforts around key vertical markets and to streamline operations. As a result of these restructuring plans in the first, second and fourth quarters of fiscal year 2003, the Company reduced its workforce by 115 employees, including 39 from the sales group, 32 from the engineering group, 23 from the professional services group, 13 from the marketing group and eight from the general and administrative group. The Company recorded restructuring charges of approximately \$2,518,000 related to employee severance costs for the year ended January 31, 2003. During the first quarter of fiscal year 2003, the Company reduced the restructuring reserve by approximately \$180,000, reflecting the payment of lower than estimated severance amounts related to previous restructuring measures. A non-cash charge of approximately \$245,000 related to the write-down to their net realizable value of capitalized assets no longer in use was also recorded during fiscal year 2003 as part of the restructuring charge.

The following table sets forth a summary of the restructuring charges, the payments made against those charges and the remaining restructuring liability as of July 31, 2003 (in thousands):

	Employee severance and other termination benefits	Estimated costs of facilities closing	Contractual obligations	Total
FY02 restructuring charges	\$ 1,578	\$ 5,212	\$ 1,338	\$ 8,128
FY03 restructuring charges	2,518	-	-	2,518
FY04 first quarter restructuring charges	325	-	-	325
FY04 second quarter restructuring charges	<u>295</u>	<u>-</u>	<u>-</u>	<u>295</u>
	4,716	5,212	1,338	11,266
Non-cash reserve	(180)	(2,014)	-	(2,194)
FY02 payments	(1,361)	(359)	(888)	(2,608)
FY03 payments	(2,167)	(726)	(130)	(3,023)
FY04 first quarter payments	(416)	(113)	(130)	(659)
FY04 second quarter payments	<u>(437)</u>	<u>(177)</u>	<u>(80)</u>	<u>(694)</u>
Accrued restructuring costs at July 31, 2003	<u>\$ 155</u>	<u>\$ 1,823</u>	<u>\$ 110</u>	<u>\$ 2,088</u>

The Company paid approximately \$694,000 and \$1,353,000 against the restructuring accruals in the three and six months ended July 31, 2003, respectively. As of July 31, 2003, unpaid amounts of approximately \$884,000 and \$1,204,000 have been classified as current and non-current accrued restructuring costs, respectively, in the accompanying consolidated balance sheet. Remaining cash expenditures relating to employee severance costs and contractual obligations will be substantially paid during the current fiscal year. The Company expects to settle amounts associated with facility closings over the remaining term of the related facility leases, which is through February 2006.

## **(8) SEGMENT REPORTING**

The Company is principally engaged in the design, development, marketing and support of enterprise search, retrieval and categorization solutions. Substantially all of the Company's revenues result from the sale of the Company's software products and related services. Accordingly the Company considers itself to be in a single reporting segment, specifically the license, implementation and support of its software. The Company's chief operating decision-making group reviews financial information presented on a consolidated basis, accompanied by disaggregated information about revenues by geographic region for purposes of making operating decisions and assessing financial performance.

### Operations by Geographic Area

The following table presents information about the Company's operations by geographical area (in thousands):

	Three Months Ended July 31,		Six Months Ended July 31,	
	2003	2002	2003	2002
Sales to Customers:				
United States	\$ 4,893	\$ 3,200	\$ 9,762	\$ 7,585
United Kingdom	1,436	853	2,151	1,692
All Other	<u>1,284</u>	<u>983</u>	<u>2,660</u>	<u>2,052</u>
	<u>\$ 7,613</u>	<u>\$ 5,036</u>	<u>\$ 14,573</u>	<u>\$ 11,329</u>

### Major Customers

For the three and six months ended July 31, 2003, revenues derived from sales to agencies of the U.S. Government were approximately \$3,043,000 and \$6,158,000, representing 40% and 42% of total revenues, respectively. For the three and six months ended July 31, 2002, revenues derived from sales to agencies of the U.S. Government were approximately \$1,170,000 and \$2,502,000, representing 23% and 22% of total revenues, respectively. No single customer accounted for 10% or more of the Company's revenues for the three and six months ended July 31, 2003 and 2002.

## **(9) INCOME TAXES**

The Company's interim effective income tax rate is based on management's best current estimate of the expected annual effective income tax rate. Based on current projections of taxable income for the year ending January 31, 2004, the Company expects that it will generate additional NOL's for the remainder of the year. As of July 31, 2003, the Company's deferred tax assets exceed its deferred tax liabilities. Given the Company's inability to predict sufficient taxable income to realize the benefits of those net deferred tax assets, the Company has provided a full valuation allowance against such deferred tax assets as of July 31, 2003.

## **(10) CONTINGENCIES**

On November 1, 2001, DSMC, Incorporated ("DSMCi") filed a complaint against the Company in the U.S. District Court for the District of Columbia in which it alleged that the Company misappropriated DSMCi's trade secrets, engaged in civil conspiracy with the NGT Library, Inc. ("NGTL"), an affiliate of the National Geographic Society, to obtain access to DSMCi's trade secrets, and was unjustly enriched by the Company's alleged access to and use of such trade secrets. In its complaint, DSMCi seeks \$5 million in actual damages and \$10 million in punitive damages from the Company. DSMCi subsequently amended its complaint to add copyright infringement-related claims. The Company is in the process of investigating the allegations and at this time believes that they are without merit.

From time to time, the Company is a party to various legal proceedings, claims, disputes and litigation arising in the ordinary course of business, including that noted above. The Company believes that the ultimate outcome of these matters, individually and in the aggregate, will not have a material adverse affect on its financial position, operations or cash flow. However, because of the nature and inherent uncertainties of litigation, should the outcome of these actions or future actions be unfavorable, Convera's financial position, operations and cash flows could be materially and adversely affected.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **Overview**

The Company principally earns revenues from the licensing of its software products and the provision of services in deployment of the Company's technology to commercial businesses and government agencies throughout North America, Europe and other parts of the world. The Company licenses its software to end users directly and also distributes its software products through license agreements with value-added resellers, system integrators, original equipment manufacturers and other strategic partners. Revenues are generated from software licenses with customers and from the related sale of product maintenance, training and implementation support services. Additions to the number of authorized users, licenses issued for additional products and the renewal of product maintenance arrangements by customers pursuant to existing licenses also provide revenues to the Company. Under software maintenance contracts, customers are typically entitled to receive telephone support, software bug fixes and upgrades or enhancements of particular software products when and if they are released.

## Results of Operations

For the quarter ended July 31, 2003, total revenues were \$7.6 million, an increase of 51% over total revenues of \$5.0 million in the same quarter last year. The net loss for the quarter ended July 31, 2003 was \$5.1 million, or \$0.18 per common share, compared to a net loss of \$9.0 million, or \$0.31 per share in the same period last year. For the six months ended July 31, 2003, total revenues were \$14.6 million, an increase of 29% over total revenues of \$11.3 million reported for the corresponding period last year. The net loss for the first half of the current fiscal year was \$11.0 million, or \$0.38 per common share, compared to a net loss of \$18.6 million, or \$0.65 per common share in the same period last fiscal year.

The following charts summarize the components of revenues and the categories of expenses, including the amounts expressed as a percentage of total revenues, for the three and six months ended July 31, 2003 and 2002, respectively (dollars in thousands).

Components of Revenues and Expenses					
	Three Months Ended July 31,		2002		Increase (Decrease)
	2003		2002		
Revenues:	\$	%	\$	%	%
License	4,587	60%	2,376	47%	93%
Professional services	1,467	19%	982	20%	49%
Maintenance	1,559	21%	1,678	33%	(7)%
	<u>\$7,613</u>	<u>100%</u>	<u>\$5,036</u>	<u>100%</u>	<u>51%</u>
Cost of revenues:					
License	454	6%	697	14%	(35)%
Professional services	1,375	18%	1,393	27%	(1)%
Maintenance	503	7%	444	9%	13%
	<u>\$2,332</u>	<u>31%</u>	<u>\$2,534</u>	<u>50%</u>	<u>(8)%</u>
Gross margin:	<u>\$5,281</u>	<u>69%</u>	<u>\$2,502</u>	<u>50%</u>	<u>111%</u>
Operating expenses:					
Sales and marketing	4,634	61%	5,162	102%	(10)%
Research and product development	3,219	42%	3,003	60%	7%
General and administrative	2,233	29%	2,381	47%	(6)%
Restructuring charge	295	4%	1,043	21%	(72)%
Amortization of intangible assets	67	1%	67	1%	0%
Total expenses	<u>\$10,448</u>	<u>137%</u>	<u>\$11,656</u>	<u>231%</u>	<u>(10)%</u>
Operating loss	<u>\$(5,167)</u>		<u>\$(9,154)</u>		
Interest income, net	<u>50</u>		<u>159</u>		
Net loss	<u><u>\$(5,117)</u></u>		<u><u>\$(8,995)</u></u>		

Components of Revenues and Expenses					
Six Months Ended July 31,					
	2003		2002		Increase (Decrease)
Revenues:	\$	%	\$	%	%
License	8,818	61%	5,986	53%	47%
Professional services	2,666	18%	1,945	17%	37%
Maintenance	3,089	21%	3,398	30%	(9)%
	<u>\$14,573</u>	<u>100%</u>	<u>\$11,329</u>	<u>100%</u>	<u>29%</u>
Cost of revenues:					
License	817	5%	1,451	13%	(44)%
Professional services	2,792	19%	3,209	28%	(13)%
Maintenance	966	7%	947	8%	2%
	<u>\$4,575</u>	<u>31%</u>	<u>\$5,607</u>	<u>49%</u>	<u>(18)%</u>
Gross margin:	<u>\$9,998</u>	<u>69%</u>	<u>\$5,722</u>	<u>51%</u>	<u>75%</u>
Operating expenses:					
Sales and marketing	9,333	64%	11,547	102%	(19)%
Research and product development	6,500	45%	6,263	55%	4%
General and administrative	4,524	31%	4,918	43%	(8)%
Restructuring charge	621	4%	1,890	17%	(67)%
Incentive bonus payments due to employees	-	0%	(138)	(1)%	100%
Amortization of intangible assets	135	1%	107	1%	26%
Acquired in-process research & development	-	0%	126	1%	(100)%
Total expenses	<u>\$21,113</u>	<u>145%</u>	<u>\$24,713</u>	<u>218%</u>	<u>(15)%</u>
Operating loss	<u>\$(11,115)</u>		<u>\$(18,991)</u>		
Interest income, net	<u>101</u>		<u>387</u>		
Net loss	<u>\$(11,014)</u>		<u>\$(18,604)</u>		

## Revenues

License revenues increased 93% to \$4.6 million for the three months ended July 31, 2003 from \$2.4 million for the three months ended July 31, 2002. License revenues for the six months ended July 31, 2003 were \$8.8 million, an increase of 47% over the license revenues of \$6.0 million reported for the corresponding period last year. The increase in license revenues for both the quarter and the first half of the current fiscal year is primarily attributable to an increase in the average deal size generating license revenue. For the three and six months ended July 31, 2003, the average deal size was approximately \$113,000 and \$120,000, respectively, while for the three and six months ended July 31, 2002, the average deal size was approximately \$52,000 and \$59,000, respectively. The overall number of transactions generating license revenue was down for the three and six months ended July 31, 2003 by approximately 2% and 20%, respectively, compared to the same periods last year.

Services revenues, which include amounts generated through software implementation and training services, increased 49% to \$1.5 million for the three months ended July 31, 2003 from \$1.0 million for the three months ended July 31, 2002. For the six months ended July 31, 2003, services revenues were \$2.7 million, an increase of 37% from \$1.9 million reported for the same period last year. The increase in services revenues is primarily attributable to revenues recognized in connection with a fixed price development agreement accounted for using the percentage of completion method of accounting. Services revenue generated from this particular agreement were approximately \$0.5 million and \$0.9 million for the three and six months ended July 31, 2003, respectively.

Software maintenance and customer support revenues decreased 7% to \$1.6 million for the three months ended July 31, 2003 from \$1.7 million in the same quarter last year. For the six months ended July 31, 2003, software maintenance and customer support revenues were \$3.1 million compared to \$3.4 million in the same period last year, representing 21% and 30% of total revenues respectively. The decrease in maintenance revenues compared to the same period last year is mainly the result of reduced license revenues during the last fiscal year, leading to an overall reduction of ongoing maintenance revenues deferred from the previous year's license business.

For the three and six months ended July 31, 2003, total revenues derived from sales to agencies of the Federal government were approximately \$3.0 million and \$6.2 million, representing 40% and 42% of total revenues, respectively. No single customer accounted for 10% or more of the Company's revenues for the three and six months ended July 31, 2003 and 2002.

Revenues from international operations are generated primarily from software licenses and related support services with various European commercial and government customers. The Company's international sales operation, Convera Technologies International, Ltd. ("CTIL"), is headquartered in the United Kingdom, with offices in Germany and France. International revenues from CTIL increased 39% for the three months ended July 31, 2003 to \$2.5 million from \$1.8 million in the same quarter last year. For the six months ended July 31, 2003, international revenues from CTIL increased 31% to \$4.6 million from \$3.5 million in the comparable period last year.

#### Cost of Revenues

Cost of license revenues decreased 35% to \$0.5 million in the second quarter of the current year from \$0.7 million in the second quarter last year. Cost of license revenues as a percentage of license revenues was 10% in the current quarter compared to 29% in the same quarter last year. For the six months ended July 31, 2003, costs of license revenues decreased 44% to \$0.8 million from \$1.5 million in the first six months of last year. As a percentage of license revenues, cost of license revenues were 9% and 24% for the six months ended July 31, 2003 and 2002, respectively. The decrease in cost of license revenues is primarily attributable to a reduction in the amortization of prepaid third-party licensing costs as well as lower documentation and freight charges.

Cost of services of \$1.4 million for the three months ended July 31, 2003 decreased by \$19,000 compared with the second quarter last fiscal year. Cost of services revenues as a percentage of services revenues was 94% in the current quarter compared to 142% in the same quarter last year. For the first six months of the current fiscal year, cost of services revenue decreased 13% to \$2.8 million from \$3.2 million in the first six months of last fiscal year. As a percentage of services revenues, cost of services revenues were 105% and 165% for the six months ended July 31, 2003 and 2002, respectively. The decrease in cost of services revenues is primarily attributable to a reduction in the overall number of employees responsible for the management and delivery of professional services. During the year ended January 31, 2003, the Company reduced the number of employees in the services organization and retained only those individuals directly responsible for the management and delivery of professional services to the Company's customers.

Cost of maintenance revenues of \$0.5 million for the three months ended July 31, 2003 increased 13% from \$0.4 million in the second quarter last fiscal year. As a percentage of maintenance revenues, cost of maintenance was 32% and 26% in the quarters ended July 31, 2003 and 2002, respectively. For the six months ended July 31, 2003, cost of maintenance revenues increased 2% to \$1.0 million from \$0.9 million in the same period last year. Cost of maintenance revenues as a percentage of maintenance revenues was 31% in the six months ended July 31, 2003 compared to 29% in the same period last year. The increase in cost of maintenance is mainly attributable to growth in the customer support organizations in the Company's international offices.

## Operating Expenses

Sales and marketing expenses decreased 10% in the quarter ended July 31, 2003 to \$4.6 million from \$5.2 million in the second quarter last fiscal year, representing 61% and 102% of total revenues, respectively. For the first six months of the current fiscal year, sales and marketing expenses decreased 19% to \$9.3 million from \$11.5 million for the corresponding period last year, representing 64% and 102% of total revenues, respectively. The decrease in sales and marketing expenses is mainly attributable to a reduction in sales, management and marketing personnel as well as decreases in marketing program expenses and travel expenses compared to the same period last year.

Total research and product development costs increased 7% to \$3.2 million in the current quarter compared to \$3.0 million in the same quarter last year. Research and product development costs as a percentage of total revenues were 42% in the current quarter compared to 60% in the second quarter last year. For the six months ended July 31, 2003, research and development expenses increased 4% to \$6.5 million from \$6.3 million for the corresponding period last year, representing 45% and 55% of total revenues, respectively. The increase is largely due to a rise in personnel costs with the addition of developers resulting from the acquisition of Semantix in March 2002 as well as an increase in third party consulting expenses related to the outsource of certain aspects of product development.

General and administrative expenses decreased 6% to \$2.2 million in the current quarter from \$2.4 million in the second quarter of last year, representing 29% and 47% of total revenues, respectively. For the six months ended July 31, 2003, general and administrative expenses decreased 8% to \$4.5 million from \$4.9 million for the corresponding period last fiscal year, representing 31% and 43% of total revenues, respectively. The decline in general and administrative expenses is primarily due to a reduction in personnel related costs as well as a decrease in legal fees. Included in general and administrative expenses for the quarter and six months ended July 31, 2003 is \$0.2 million of amortized deferred stock compensation expense. Such deferred compensation was recorded in connection with a deferred stock grant to certain Convera employees under the Company's 2000 Stock Option Plan.

During the first quarter of the current fiscal year, the Company adopted a restructuring plan in its continued effort to streamline operations. In connection with this reorganization, the Company reduced its workforce by 11 employees worldwide, including four individuals from the G&A group, four from the marketing group, two from the sales group and one from the engineering group. The Company recorded a restructuring charge of \$0.3 million related to severance costs for terminated employees.

In the current quarter ended July 31, 2003, the Company announced an additional reduction in force. As a result of this action, the Company reduced its workforce by 17 employees worldwide, including nine individuals from the engineering group, three from the sales group, three from the professional services group and two from the marketing group. The Company recorded a restructuring charge of \$0.3 million related to severance costs for terminated employees.

In the quarter ended July 31, 2002, the Company recorded a restructuring charge of approximately \$1.0 million related to employee severance costs in its effort to align its operations around key vertical markets. The restructuring resulted in the reduction of Convera's total workforce by 42 employees worldwide, including 15 from the sales group, seven individuals from the engineering group, seven from the professional services group, seven from the marketing group and six from the general and administrative group. A non-cash reserve adjustment of \$0.2 million related to the write-down of capitalized assets was also recorded during the quarter ended July 31, 2002. During the quarter ended April 30, 2002, the Company recorded a restructuring charge of approximately \$1.0 million related to employee severance costs. In connection with this reorganization, the Company reduced its workforce by 61 employees worldwide, including 24 individuals from the engineering group, 16 from the sales group, 13 from the professional services group, six from the marketing group and two from the general and administrative group. During the quarter ended April 30, 2002, the Company also reduced the existing restructuring reserve by approximately \$0.2 million, reflecting the payment of lower than estimated severance amounts related to restructuring actions taken in the second and third quarters of the fiscal year ended January 31, 2002.

The Company paid approximately \$0.7 million and \$1.4 million against the restructuring accruals in the three and six months ended July 31, 2003, respectively. As of July 31, 2003, unpaid amounts of approximately \$0.9 million and \$1.2 million have been classified as current and non-current accrued restructuring costs, respectively, in the accompanying consolidated balance sheet. Remaining cash expenditures relating to employee severance costs and contractual obligations will be substantially paid during the current fiscal year. The Company expects to settle amounts associated with facility closings over the remaining term of the related facility leases, which is through February 2006.

#### Incentive bonus payments due to employees

Specified former Intel employees who became Convera employees and remained employed through September 30, 2002 are receiving payments representing the excess of the calculated aggregate gain they would have realized on forfeited Intel stock options that would have vested between 2002 and 2005, based on the fair value of Intel shares at a fixed date prior to the closing of the business combination transaction with Intel (the "Combination"), over the calculated aggregate gain on Convera stock options as of September 30, 2002. For the quarter ended April 30, 2002, the Company reversed approximately \$138,000 of incentive bonus expense previously recorded, due to a reduction in the number of former Intel employees remaining with the Company as of April 30, 2002. The Company made payments of \$329,000 and \$657,000 related to these incentive bonuses in the three and six months ended July 31, 2003, and the remaining \$219,000 will be paid out within the next quarter.

#### Amortization of intangible assets

Amortization of intangible assets was \$67,000 and \$135,000 for the three and six months ended July 31, 2003, respectively. For the three and six months ended July 31, 2002, amortization of intangible assets was \$67,000 and \$107,000, respectively. This amount represents amortization of developed technology related to the Company's acquisition of Semantix Inc., which was accounted for using the purchase method of accounting.

#### Acquired in-process research and development

In connection with the acquisition of Semantix Inc., the Company recorded a charge for acquired in-process research and development of \$126,000 in the quarter ended April 30, 2002.

#### Interest income, net

Net interest income decreased to \$50,000 for the second quarter of the current fiscal year, compared to \$159,000 in the second quarter of last fiscal year. For the six months ended July 31, 2003, net interest income decreased to \$101,000 from \$387,000 in the same period of last year. The decrease is a result of lower interest income largely due to a lower level of invested funds as well as to lower interest rates in the current fiscal year.

### **Liquidity and Capital Resources**

The Company's combined balance of cash, cash equivalents and short-term investments at July 31, 2003 as compared to January 31, 2003 is summarized below (in thousands).

	July 31, 2003	January 31, 2003	Change
Cash and cash equivalents	\$ 31,227	\$ 10,318	\$ 20,909
Investments	5,355	20,148	(14,793)
Total	<u>\$ 36,582</u>	<u>\$ 30,466</u>	<u>\$ 6,116</u>

During the six months ended July 31, 2003, the Company used cash of \$9.8 million to fund operating activities, compared to \$15.4 million used in the same period last year. The net loss of \$11.0 million was offset by non-cash charges totaling \$1.4 million including depreciation of \$0.9 million, bad debt expense of \$0.2 million, amortization of \$0.1 million, and amortization of deferred stock compensation of \$0.2 million. Increases in accounts payable, accrued expenses and accrued bonuses as well as an increase in deferred revenues provided \$1.4 million, while increases in accounts receivable, prepaid expenses and other assets used \$0.9 million. The decrease in the restructuring reserve used a net of \$0.7 million. During the six months ended July 31, 2002, \$15.4 million was used to fund operating activities. The net loss of \$18.6 million was offset by non-cash charges totaling \$1.6 million, including depreciation of \$1.2 million, bad debt expense of \$0.2 million, amortization of \$0.1 million and in-process research and development of \$0.1 million. Cash was provided by reductions in accounts receivable of \$1.9 million and prepaid expenses and other assets of \$2.3 million. Decreases in accounts payable, accrued expenses and accrued bonuses and a reduction in deferred revenues reduced cash from operating activities by \$2.3 million. The decrease in the restructuring reserve used a net of \$0.2 million.

Cash flows from investing activities provided the Company \$14.6 million in the first six months of the current fiscal year. Net cash provided from the maturity of U.S. Treasury Bills provided \$14.8 million, while purchases of equipment and leasehold improvements used cash of \$0.2 million. For the six months ended July 31, 2002, the Company's investing activities provided \$19.3 million. Net cash provided from the maturity of U.S. Treasury Bills provided \$19.7 million while purchases of equipment and leasehold improvements used cash of \$0.6 million. Cash acquired as a result of the purchase of Semantix Inc. was approximately \$0.4 million netted against direct acquisition costs of approximately \$0.3 million.

Financing activities provided cash of \$16.2 million for the six months ended July 31, 2003. Net proceeds of \$16.0 million was provided by a private placement of 4,714,111 shares of common stock to a group of unaffiliated institutional investors at a purchase price of \$3.60 per share. Approximately \$78,000 was provided from the issuance of stock under the employee stock purchase plan, and \$83,000 was provided from the exercise of employee stock options. For the six months ended July 31, 2002, financing activities provided cash of \$128,000, of which \$114,000 was provided from the issuance of stock under the employee stock purchase plan, and \$14,000 was provided from the exercise of employee stock options.

At July 31, 2003, the Company's balance of cash, cash equivalents and short-term investments was \$36.6 million. The Company believes that its current balance of cash, cash equivalents and short-term investments and its funds generated from operations, if any, will be sufficient to fund the Company's current projected cash needs for the foreseeable future. If the actions taken by management are not effective in achieving profitable operating results, the Company may be required to pursue additional external sources of financing to support its operations and capital requirements. There can be no assurance that external sources of financing will be available if required, or that such financing will be available on terms acceptable to the Company.

The Company has the following contractual obligations associated with its lease commitments and other contractual obligations:

Contractual Obligations	Payments Due By Period (in thousands)					
	<u>Total</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
Operating leases	\$7,185	\$1,931	\$2,770	\$1,570	\$851	\$63

## **Forward Looking Statements**

Certain written and oral statements made by the Company may constitute "forward-looking statements" as defined under the Private Securities Litigation Reform Act of 1995, including statements made in this report and other filings with the Securities and Exchange Commission. Generally, the words "believe," "expect," "intend," "estimate," "anticipate," "project," "will" and similar expressions identify forward-looking statements, which generally are not historical in nature. All statements which address operating performance, events or developments that we expect or anticipate will occur in the future including statements relating to volume growth, share of sales and earnings per share growth and statements expressing general optimism about future operating results are forward-looking statements. Forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from our Company's historical experience and our present expectations or projections. As and when made, management believes that these forward-looking statements are reasonable. However, caution should be taken not to place undue reliance on any such forward-looking statements since such statements speak only as of the date when made. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

The following are some of the factors that could cause the Company's actual results to differ materially from the expected results described in or underlying the Company's forward-looking statements:

### **The Company has had a history of operating losses and may incur future losses**

The Company believes that its future profitability will depend on its ability to effectively market existing and newly developed software products through a balanced multi-channel distribution network. Convera cannot assure that its costs to develop, introduce and promote enhanced or new products will not exceed its expectations, or that these products will generate revenues sufficient to offset these expenses. The Company has operated at a loss for each of the past three fiscal years. These losses reflect the Company's expenditures associated with selling software products and further developing software products during these years. Convera plans to continue to invest in the development, sales and marketing of its products and, accordingly, the Company cannot assure that its operating losses will not continue in the future.

### **The Company experiences quarterly fluctuations in its operating results, which may adversely affect the Company's stock price**

Convera's quarterly operating results have varied substantially in the past and are likely to vary substantially from quarter to quarter in the future, due to a variety of factors including the following:

- the downturn in capital spending by customers as a result of an economic slowdown;
- the delay or deferral of customer implementations;
- the budget cycles of the Company's customers;
- seasonality of individual customer buying patterns;
- an increase in competition in the software industry;
- the size and timing of individual transactions;
- the timing of new software introductions and software enhancements by the Company and its competitors;
- changes in operating expenses and personnel;
- changes in accounting principles, such as a requirement that stock options be included in compensation, as is currently being considered by Congress and, which, if adopted, would increase the Company's compensation expense and have a negative effect on earnings;
- the overall trend towards industry consolidation; and
- changes in general economic and geo-political conditions and specific economic conditions in the computer and software industries.

In particular, Convera's period-to-period operating results have historically been significantly dependent upon the timing of the closing of significant license agreements. Because purchasing the Company's products often requires significant capital investment, Convera's customers may defer or decide not to make their purchases. This means sales can involve long sales cycles of six months or more. The Company has generally recorded a significant

portion of its total quarterly license revenues in the third month of a quarter, with a concentration of these revenues occurring in the last half of that third month. This is in part because customers tend to make significant capital expenditures at the end of a fiscal quarter. The Company expects these revenue patterns to continue. Despite these uncertainties in Convera's revenue patterns, its operating expenses are based upon anticipated revenue levels and are incurred on an approximately ratable basis throughout a quarter. As a result, if expected revenues are deferred or otherwise not realized in a quarter for any reason, the Company's business, operating results and financial condition would be materially adversely affected.

**A portion of the Company's revenues is derived from sales to federal government agencies, which are subject to budget cuts. The ability to complete contracts with the federal government, and size and timing of those contracts may materially affect the Company's operating results**

For the three and six months ended July 31, 2003, revenues derived from sales to agencies of the U.S. Government were approximately \$3,043,000 and \$6,158,000, representing 40% and 42% of total revenues, respectively. For the three and six months ended July 31, 2002, revenues derived from sales to agencies of the U.S. Government were approximately \$1,170,000 and \$2,502,000, representing 23% and 22% of total revenues, respectively. While the federal government has recently increased spending on defense and homeland security initiatives, many government agencies have had budget freezes or reductions which may adversely impact their purchasing decisions and timing.

The Company is actively pursuing several opportunities for business with certain U.S. Government agencies. While the nature and timing of these opportunities, as well as the ability to complete business transactions related to these opportunities, is subject to certain risks and uncertainties, successful completion of any of these transactions could have a material impact on the future operating results and financial position of the Company. There can be no assurance that the Company will complete any of these potential transactions.

**The Company is dependent on international sales, which expose it to foreign political and economic risks**

A material portion of Convera's revenues is derived from international sales. The Company's international operations expose it to a variety of risks that could impede the Company's financial condition and growth. These risks include the following:

- difficulties in complying with regulatory requirements and standards;
- political, social and economic instability;
- longer accounts receivable and payment cycles;
- trade restrictions and changes in tariffs;
- potentially adverse tax consequences;
- import and export license requirements and restrictions;
- fluctuations in currency exchange rates; and
- uncertainty of the effective protection of the Company's intellectual property rights in certain foreign countries.

If any of these risks described above materialize, the Company's international sales could decrease and its foreign operations could suffer.

**Convera is in a competitive market, and if the Company fails to compete effectively or respond to rapid technological change, its revenues and market share will be adversely affected**

The Company's business environment and the software industry in general are characterized by intense competition, rapid technological changes, changes in customer requirements and emerging new market segments. Convera's competitors include many companies that are larger and more established and have substantially more resources than it does. Current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address the needs of the markets served by Convera. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. Increased competition may result in price reductions, reduced gross margins and loss of market share, any of which could have a material adverse effect on the Company's business, financial

condition or results of operations.

In order for Convera's strategy to succeed and to remain competitive, it must leverage its core technology to develop new product offerings. These development efforts are expensive. If these products do not generate substantial revenues, the Company's business and results of operations will be adversely affected. The Company cannot assure that any of these products will be successfully developed, completed on a timely basis or at all, achieve market acceptance or generate significant revenues.

**Convera designs its products to work with certain systems and changes to such systems may render Convera's products incompatible with these systems**

Convera's ability to sell its products depends on the compatibility of its products with other software and hardware products. These products may change or new products may appear that are incompatible with the Company's products. If the Company fails to adapt its products to remain compatible with other vendors' software and hardware products or fails to adapt its products as quickly as its competitors, Convera may be unable to sell its products.

**The Company's software products are complex and may contain errors that could damage its reputation and decrease sales**

Convera's complex software products may contain errors that may be detected at any point in the products' life cycles. The Company cannot assure that, despite Convera's testing and quality assurance efforts and similar efforts by current and potential customers, errors will not be found. The discovery of an error may result in loss of or delay in market acceptance and sales.

**The Company is dependent on proprietary technology licensed from third parties, the loss of which could delay shipments of products incorporating this technology and could be costly**

Some of the technology used by the Company's products is licensed from third parties, generally on a nonexclusive basis. The Company believes that there are alternative sources for each of the material components of technology it licenses from third parties. However, the termination of any of these licenses, or the failure of the third-party licensors to adequately maintain or update their products, could result in delay in the Company's ability to ship these products while the Company seeks to implement technology offered by alternative sources. Any required replacement licenses could prove costly. Also, any delay, to the extent it becomes extended or occurs at or near the end of a fiscal quarter, could harm the Company's quarterly results of operations. While it may be necessary or desirable in the future to obtain other licenses relating to one or more of the Company's products or relating to current or future technologies, the Company cannot assure that it will be able to do so on commercially reasonable terms or at all.

**Because of the technical nature of Convera's business, its intellectual property is extremely important to Convera's business, and adverse changes to its intellectual property would harm the Company's competitive position**

Convera believes that its success depends, in part, on its ability to protect its proprietary rights and technology. Historically, Convera has relied primarily on a combination of copyright, patents, trademark and trade secret laws, employee confidentiality and invention assignment agreements, distribution and OEM software protection agreements and other methods to safeguard the Company's technology and software products. Risks associated with the Company's intellectual property, include the following:

- pending patent applications may not be issued;
- intellectual property laws may not protect the Company's intellectual property rights;
- third parties may challenge, invalidate, or circumvent any patent issued to the Company;
- rights granted under patents issued to Convera may not provide competitive advantages to the Company;
- unauthorized parties may attempt to obtain and use information that Convera regards as proprietary despite Convera's efforts to protect its proprietary rights;

- others may independently develop similar technology or design around any patents issued to Convera; and
- effective protection of intellectual property rights may be limited or unavailable in some foreign countries in which the Company operates.

#### **The Company's operations could infringe on the intellectual property rights of others**

The Company cannot assure that a third party will not assert that the Company's technology violates its intellectual property rights. Particular aspects of Convera's technology could be found to infringe on the intellectual property rights of others. Other companies may hold or obtain patents on inventions or may otherwise claim proprietary rights to technology necessary to the Company's business. The Company cannot predict the extent to which it may be required to seek licenses or alter its products so that they no longer infringe the rights of others. The Company cannot guarantee that the terms of any licenses it may be required to seek will be reasonable. Similarly, changing Convera's products or processes to avoid infringing the rights of others may be costly or impractical or could detract from the value of the Company's products.

#### **If Convera is unable to manage its growth successfully, it may divert Convera's resources and harm its operating results**

The Company's future operating results will be affected by its ability to expand its product distribution channels and to manage its expected growth. Convera's future results may also be impacted by its ability to execute future acquisitions and integrate the operations of acquired companies with Convera's. If Convera cannot effectively manage its expanding operations, it may not be able to grow, or the Company may grow at a slower pace. Convera's failure to successfully manage growth and to develop financial controls and accounting and operating systems or to add and retain personnel that adequately support the Company's growth would harm its business and financial results.

#### **Convera depends on its key personnel and may have difficulty attracting and retaining skilled employees**

Convera's success depends to a significant degree upon the continued contributions of its key management, marketing, technical and operational personnel. The Company generally does not utilize employment agreements for its key employees. The loss of the services of one or more key employees could have a material adverse effect on the Company's operating results. The Company also believes its future success will depend in large part upon its ability to attract and retain additional highly skilled management, technical, marketing, product development, and operational personnel. Competition for such personnel is intense, and pay scales in the software industry have significantly increased. There can be no assurance that the Company will be successful in attracting and retaining such personnel.

#### **The Company may not be able to use net operating loss carryforwards**

As of January 31, 2003, the Company had net operating loss carryforwards of approximately \$142 million. The deferred tax assets representing the benefits of these carryforwards have been offset completely by a valuation allowance due to the Company's lack of an earnings history. The realization of the benefits of these carryforwards depends on sufficient taxable income in future years. Lack of future earnings could adversely affect Convera's ability to utilize these carryforwards. Additionally, past or future changes in Convera's ownership and control could limit the ability to utilize these carryforwards. Despite the carryforwards, the Company may have income tax liability in future years due to the application of the alternative minimum tax rules of the United States Internal Revenue Code.

#### **The Company may need additional capital in the future, and it may not be available on acceptable terms, or at all**

The Company expects that its current cash and cash equivalents will be sufficient to meet its working capital and capital expenditure requirements for the foreseeable future. However, the Company may need to raise additional funds for the following purposes:

- to fund the Company's operations;
- to fund any growth the Company experiences;
- to enhance and/or expand the range of services Convera offers;
- to increase the Company's promotional and marketing activities; or
- to respond to competitive pressures and/or perceived opportunities, such as investment, acquisition and international expansion activities.

The Company cannot assure that necessary capital will be available, and if so, on terms beneficial to the Company.

**Convera's stock price may fluctuate which may make it difficult to resell shares of Convera stock**

The market price of Convera's common stock and its trading volume have been highly volatile. This volatility may adversely affect the price of Convera's common stock, and Convera stockholders may not be able to resell their shares of common stock following periods of volatility because of the market's adverse reaction to this volatility. The Company anticipates that this volatility, which frequently affects the stock of software companies, will continue. Factors that could cause such volatility include:

- future announcements concerning Convera or its competitors;
- quarterly variations in the Company's operating results;
- actual or anticipated announcements of technical innovations or new product developments by Convera or its competitors;
- general conditions in the Company's industry;
- intellectual property or other litigation; and
- worldwide economic and financial conditions.

On occasion, the equity markets, and in particular the markets for software companies, have experienced significant price and volume fluctuations. These fluctuations have affected the market price for many companies' securities even though the fluctuations are often unrelated to the companies' operating performance.

**The Company's amended and restated certificate of incorporation, bylaws, ownership and Delaware law contain provisions that could discourage a third party from acquiring the Company and consequently decrease the market value of an investment in Convera stock**

Some provisions of the Company's amended and restated certificate of incorporation and bylaws and of Delaware law could delay or prevent a change of control or changes in the Company's management that a stockholder might consider favorable. Any delay or prevention of a change of control or change in management could cause the market price of the Company's common stock to decline.

**Allen Holding Inc. and related parties exercise voting control over the Company and their interests may differ from those of other Convera stockholders**

Further, Allen Holding, Inc., together with Allen & Company Incorporated, Herbert A. Allen and certain related parties (collectively "Allen & Company") beneficially own more than 50% of the voting power of Convera, and would therefore be able to control the outcome of matters requiring a stockholder vote. These matters could include offers to acquire Convera and elections of directors. Allen & Company may have interests that are different than the interests of other Convera stockholders.

### **Item 3. Quantitative and Qualitative Disclosure About Market Risk**

The Company's market risk is principally confined to changes in foreign currency exchange rates and potentially adverse effects of differing tax structures. International revenues from CTIL, the Company's foreign sales subsidiary located in the United Kingdom, along with entities established in Paris, France and Munich, Germany, were approximately 33% and 32% of total revenues in the first three and six months of the current fiscal year, respectively. International sales are made mostly from the Company's foreign subsidiary and are typically denominated in British pounds or EUROS. As of July 31, 2003, approximately 24% and 9% of total consolidated accounts receivable were denominated in British pounds and EUROS, respectively. Additionally, the Company's exposure to foreign exchange rate fluctuations arises in part from intercompany accounts in which royalties on CTIL sales are charged to CTIL and recorded as intercompany receivables on the books of the U.S. parent company. The Company is also exposed to foreign exchange rate fluctuations as the financial results of CTIL are translated into U.S. dollars in consolidation. As exchange rates vary, those results when translated may vary from expectations and adversely impact overall expected profitability.

As of July 31, 2003, 5% of the Company's cash and cash equivalents balance was included in the Company's foreign subsidiaries. Cash equivalents consist of funds deposited in money market accounts with original maturities of three months or less. The Company's short-term investments consist primarily of U.S. Government treasury bills, with maturity dates ranging from three to six months. Given the relatively short maturity periods of cash equivalents and short-term investments, the Company's exposure to fluctuations in interest rates is limited.

### **Item 4. Controls and Procedures**

Within the 90-day period prior to the filing of this report, the Company, under the supervision and with the participation of its management, including the Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company's "disclosure controls and procedures" (as defined in Rule 13a-14(c) under the Securities Exchange Act of 1934 (the "Exchange Act")). Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in making known to them, on a timely basis, material information required to be disclosed in the Company's reports filed or submitted under the Exchange Act. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect the internal controls subsequent to the date the Company completed its evaluation.

## PART II-- OTHER INFORMATION

Item 1. Legal Proceedings None.

Item 2. Changes in Securities

On July 30, 2003, the Company completed a private placement of 4,714,111 shares (the "Shares") of its common stock to a group of unaffiliated institutional investors. The private placement was made pursuant to an exemption from registration under Section 4(2) and Regulation D of the Securities Act of 1933, as amended, to a limited number of "accredited investors", as such term is defined in Regulation D. The Company sold the Shares at a purchase price of \$3.60 per share, resulting in gross proceeds to the Company of approximately \$17 million. In connection with this private placement, the Company incurred expenses of approximately \$940,000, which have been recorded in equity as an offset against the proceeds. The Company plans to use the net proceeds to finance ongoing operations and for general corporate purposes, including potential acquisitions. Allen & Company LLC acted as placement agent for the private placement and was paid a commission of 5%, which is included in the offering expenses above.

Item 3. Defaults upon Senior Securities None.

Item 4. Submission of Matters to Vote of Security Holders

The 2003 Annual Meeting of Shareholders was held June 25, 2003. The following individuals were elected to serve as the Board of Directors for terms expiring at the 2004 Annual Meeting:

	Number of Shares Voted	
	For	Withheld
Ronald J. Whittier	26,411,285	183,804
Herbert A. Allen	26,468,685	126,404
Herbert A. Allen III	26,528,545	66,544
Patrick C. Condo	26,411,245	183,844
Stephen D. Greenberg	26,468,645	126,444
Eli S. Jacobs	26,528,545	66,544
Donald R. Keough	26,528,556	66,533
William S. Reed	26,528,546	66,543
Carl J. Rickertsen	26,528,586	66,503
Jeffrey White	26,528,526	66,563

Item 5. Other Information None.

Item 6.

Exhibits and Reports on Form 8-K

a) Exhibits

- 31.1 Certification of Chief Executive Officer pursuant to Securities Exchange Act of 1934 Rules 13a-14(a) and 15d-14(a)
- 31.2 Certification of Chief Financial Officer pursuant to Securities Exchange Act of 1934 Rules 13a-14(a) and 15d-14(a)
- 32.1 Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

b) Reports on Form 8-K

On May 28, 2003, the Company filed a Form 8-K for Items 5 and 9, announcing that Carl J. (Rick) Rickertsen and Jeffrey White have joined the Company's Board of Directors and furnishing the Company's financial results for the quarter ended April 30, 2003.

On July 31, 2003, the Company filed a Form 8-K for Item 5, announcing that the Company accepted subscriptions for the sale of a total of 4,714,111 newly issued shares of common stock in a private placement to a group of institutional investors. The shares were priced at \$3.60 per share on July 23, 2003.

## 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.

### CONVERA CORPORATION

September 15, 2003

By: /s/ Patrick C. Condo  
Patrick C. Condo  
President and Chief Executive Officer  
(Principal Executive Officer)

September 15, 2003

By: /s/ Christopher M. Mann  
Christopher M. Mann  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

CERTIFICATION PURSUANT TO  
SECURITIES EXCHANGE ACT OF 1934  
RULES 13a-14(a) AND 15d-14(a)

In connection with the Quarterly Report of Convera Corporation (the "Company") on Form 10-Q for the period ended July 31, 2003 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Patrick C. Condo, President and Chief Executive Officer of the Company, certify, pursuant to Securities Exchange Act of 1934 Rules 13a-14(a) and 15d-14(a), that:

- (1) I have reviewed this quarterly report on Form 10-Q of Convera Corporation;
- (2) Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
- (3) Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
- (4) The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and
  - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- (5) The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

By: /s/ Patrick C. Condo

Patrick C. Condo

President and Chief Executive Officer

September 15, 2003

CERTIFICATION PURSUANT TO  
SECURITIES EXCHANGE ACT OF 1934  
RULES 13a-14(a) AND 15d-14(a)

In connection with the Quarterly Report of Convera Corporation (the "Company") on Form 10-Q for the period ended July 31, 2003 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Christopher M. Mann, Chief Financial Officer of the Company, certify, pursuant to Securities Exchange Act of 1934 Rules 13a-14(a) and 15d-14(a), that:

- (1) I have reviewed this quarterly report on Form 10-Q of Convera Corporation;
- (2) Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
- (3) Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
- (4) The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- (5) The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

By: /s/ Christopher M. Mann  
Christopher M. Mann  
Chief Financial Officer  
September 15, 2003

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Convera Corporation (the "Company") on Form 10-Q for the period ended July 31, 2003 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Patrick C. Condo, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ Patrick C. Condo  
Patrick C. Condo  
President and Chief Executive Officer  
September 15, 2003

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Convera Corporation (the "Company") on Form 10-Q for the period ended July 31, 2003 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Christopher M. Mann, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ Christopher M. Mann  
Christopher M. Mann  
Chief Financial Officer  
September 15, 2003