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NETEGRITY INC
Form 8-K/A
February 13, 2002

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 8-K/A

AMENDMENT NO. 1 TO CURRENT REPORT

Current Report Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): December 14, 2001

Netegrity, Inc.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation)	1-10139 (Commission File Number)	04-2911320 (IRS Employer Identification No.)
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52 Second Avenue Waltham, MA (Address of principal executive offices)	02451 (Zip Code)
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Registrant's telephone number, including area code: (781) 890-1700

N/A

(Former name or former address, if changed since last report)

INTRODUCTORY NOTE

On December 14, 2001, Netegrity, Inc. (the "Company") completed its acquisition (the "Acquisition") of DataChannel, Inc. On December 24, 2001, the Company filed a Current Report on Form 8-K (the "Current Report") to report the Acquisition. The purpose of this Amendment No. 1 to the Current Report is to file the financial statements required by Item 7.

The Company hereby amends Item 7 of the Current Report to read in its entirety as follows:

ITEM 7. FINANCIAL STATEMENTS AND EXHIBITS.

(a) Financial Statements of the Business Acquired.

The required financial statements are attached hereto on pages 3

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through 32.

(b) Pro Forma Financial Information.

The required pro forma financial information is attached hereto on pages 33 through 39.

(c) Exhibits.

2.1* Agreement and Plan of Merger dated as of October 24, 2001 by and among Netegrity, Inc., LKN Acquisition Corp., and DataChannel, Inc., as amended by the First Amendment to the Agreement and Plan of Merger, dated as of December 3, 2001 and the Second Amendment to the Agreement and Plan of Merger, dated as of December 7, 2001.

23.1 Consent of Ernst & Young LLP, Independent Auditors

23.2 Consent of Arthur Andersen, LLP

* Previously filed.

Item 7. (a)

DATACHANNEL, INC.
CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

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To the Board of Directors
DataChannel, Inc.

We have audited the accompanying consolidated balance sheet of DataChannel, Inc. as of December 31, 2000, and the related consolidated statements of operations, convertible preferred stock and shareholders' deficit, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of DataChannel, Inc. as of December 31, 2000, and the consolidated results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States.

As discussed in Note 1 to the consolidated financial statements, the Company's recurring net losses and negative cash flows from operations raise substantial doubt about its ability to continue as a going concern. Management's plans as to these matters are described in Note 1. The 2000 consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Ernst & Young LLP

Seattle, Washington
June 1, 2001

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REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Board of Directors of
DataChannel, Inc.

We have audited the accompanying consolidated balance sheet of DataChannel, Inc. (a Washington corporation) and subsidiary as of December 31, 1999, and the related consolidated statements of operations, convertible preferred stock and shareholders' deficit and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our

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opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of DataChannel, Inc. and subsidiary as of December 31, 1999, and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States.

/s/ Arthur Andersen LLP

Seattle, Washington
May 24, 2000

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DataChannel, Inc.

Consolidated Balance Sheets

	DECEMBER 31	
	1999	

ASSETS		
Current assets:		
Cash and cash equivalents	\$ 4,250,518	\$
Short-term investments	--	
Accounts receivable, net of allowance of \$198,000 and \$150,000 at December 31, 1999 and 2000, respectively (150,000 at September 30, 2001)	2,515,160	
Prepaid expenses and other current assets	210,594	

Total current assets	6,976,272	
Property and equipment, net	1,204,852	
Other assets	69,639	
Goodwill and other intangible assets, net of accumulated amortization of \$1,281,738 and \$3,244,648 at December 31, 1999 and 2000, respectively (\$5,123,937 at September 30, 2001)	2,417,713	

Total assets	\$ 10,668,476	\$
	=====	
LIABILITIES AND SHAREHOLDERS' DEFICIT		
Current liabilities:		
Accounts payable	\$ 1,156,795	\$
Accrued payroll and other accrued expenses	785,659	
Deferred revenue	1,463,033	
Convertible subordinated notes payable	5,023,014	
Current portion of notes payable	12,215	

Total current liabilities	8,440,716	
Notes payable, less current portion	1,815,457	

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Commitments

Convertible preferred stock, \$0.01 par value; authorized shares -- 6,935,073 and 14,977,838 at December 31, 1999 and 2000, respectively (14,977,838 at September 30, 2001); issued and outstanding 6,853,744 and 14,898,511 at December 31, 1999 and 2000, respectively (14,898,511 at September 30, 2001), preference in liquidation of \$57,823,334 at December 31, 2000 and September 30, 2001	12,295,044
Shareholders' deficit:	
Common stock, \$0.01 par value; authorized shares -- 25,000,000 and 75,000,000 at December 31, 1999 and 2000, respectively (75,000,000 at September 30, 2001); issued and outstanding shares -- 10,179,612 and 14,743,032 at December 31, 1999 and 2000, respectively (13,404,441 at September 30, 2001)	1,644,521
Notes receivable on restricted stock	--
Deferred stock compensation	(463,102)
Accumulated other comprehensive income	--
Accumulated deficit	(13,064,160)
Total shareholders' deficit	(11,882,741)
Total liabilities and shareholders' deficit	\$ 10,668,476

See accompanying notes.

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DataChannel, Inc.

Consolidated Statements of Operations

	YEAR ENDED DECEMBER 31	
	1999	2000
Revenue:		
License	\$ 2,776,039	\$ 5,975,239
Services	4,624,007	8,573,703
Total revenue	7,400,046	14,548,942
Cost of sales:		
Cost of license fees	159,544	877,228
Cost of services	2,571,416	6,640,180
Total cost of sales	2,730,960	7,517,408
Gross profit	4,669,086	7,031,534
Operating expenses:		

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Sales and marketing (including stock-based compensation of \$62,717 and \$147,299 in the years ended December 31, 1999 and 2000, respectively, and \$68,602 and \$59,872 in the nine months ended September 30, 2000 and 2001, respectively)	6,157,473	18,790,495
Product development (including stock-based compensation of \$63,523 and \$149,192 in the years ended December 31, 1999 and 2000, respectively and \$112,064 and \$59,350 in the nine months ended September 30, 2000 and 2001, respectively)	3,957,597	9,531,927
General and administrative (including stock-based compensation of \$422,142 and \$991,455 in the years ended December 31, 1999 and 2000, respectively and \$879,807 and \$(715,220) in the nine months ended September 30, 2000 and 2001, respectively)	2,170,580	5,453,551
Amortization of goodwill and other intangible assets	1,281,738	1,962,911
Total operating expenses	13,567,388	35,738,884
Operating loss	(8,898,302)	(28,707,350)
Interest income	117,839	1,589,971
Interest expense	(67,814)	(1,166,572)
Net loss	\$ (8,848,277)	\$ (28,283,951)
Basic and diluted loss per share	\$ (.91)	\$ (2.67)
Weighted average shares used in basic and diluted loss per share computation	9,705,031	10,589,966

See accompanying notes.

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DataChannel, Inc.

Consolidated Statements of Convertible Preferred Stock and Shareholders' Deficit

	CONVERTIBLE PREFERRED STOCK		S
	SHARES	AMOUNT	
Balance at January 1, 1999	5,737,222	\$ 4,961,612	9,2
Exercise of common stock options for cash	--	--	3
Common stock issued in business acquisitions	--	--	5
Repurchase of Series B preferred stock for cash	(1,586,583)	(1,697,961)	
Series C preferred stock issued for cash, net of offering costs	2,703,105	9,031,393	
Deferred compensation	--	--	

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Amortization of deferred compensation	--	--	
Net loss	--	--	
Balance at December 31, 1999	6,853,744	12,295,044	10,1
Exercise of common stock options	--	--	5,0
Common stock issued in business acquisition	2	--	2
Repurchases of common stock	--	--	(7
Series D preferred stock issued for cash, and conversion of notes payable net of offering costs of \$165,425	8,044,765	44,834,576	
Fair value of warrants and beneficial conversion feature related to convertible notes	--	--	
Employee stock-based compensation	--	--	
Nonemployee stock-based compensation expense	--	--	
Amortization of deferred compensation expense	--	--	
Comprehensive loss:			
Change in net unrealized gain on investments	--	--	
Net loss	--	--	
Comprehensive loss			
Balance at December 31, 2000	14,898,511	\$ 57,129,620	14,7

	NOTES RECEIVABLE FROM SHAREHOLDERS	DEFERRED COMPENSATION	ACCUMULATED OTHER COMPREHENSIVE INCOME
Balance at January 1, 1999	\$ --	\$ --	\$ --
Exercise of common stock options for cash	--	--	--
Common stock issued in business acquisitions	--	--	--
Repurchase of Series B preferred stock for cash	--	--	--
Series C preferred stock issued for cash, net of offering costs	--	--	--
Deferred compensation	--	(1,011,484)	--
Amortization of deferred compensation	--	548,382	--
Net loss	--	--	--
Balance at December 31, 1999	--	(463,102)	--
Exercise of common stock options	(1,870,448)	--	--
Common stock issued in business acquisition	--	--	--
Repurchases of common stock	--	--	--
Series D preferred stock issued for cash and conversion of notes payable, net of offering costs of \$165,425	--	--	--
Fair value of warrants and beneficial conversion feature related to convertible notes	--	--	--
Employee stock-based compensation	--	(338,250)	--
Nonemployee stock-based compensation expense	--	--	--
Amortization of deferred compensation expense	--	--	--
Comprehensive loss:	--	349,512	--

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Change in net unrealized gain on investments	--	--	11,192
Net loss	--	--	--
Comprehensive loss			
Balance at December 31, 2000	\$ (1,870,448)	\$ (451,840)	\$ 11,192

See accompanying notes.

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DataChannel, Inc.

Consolidated Statements of Cash Flows

	YEAR ENDED DECEMBER 31	
	1999	2000
OPERATING ACTIVITIES		
Net loss	\$ (8,848,277)	\$ (28,283,951)
Adjustments to reconcile net loss to net cash and cash equivalents used in operating activities:		
Depreciation and amortization	1,720,813	3,038,951
Stock-based compensation	548,382	1,287,946
Noncash interest expense	--	1,075,540
Provision for doubtful accounts	91,022	(48,000)
Changes in assets and liabilities, net of assets acquired in business combination:		
Accounts receivable	(303,506)	600,007
Prepaid expenses and other current assets	(15,287)	(1,144,180)
Other assets	38,782	(27,548)
Accounts payable	763,391	1,352,064
Accrued payroll and other accrued expenses	455,069	817,062
Deferred revenue	203,465	2,680,878
Net cash and cash equivalents used in operating activities	(5,346,146)	(18,651,231)
INVESTING ACTIVITIES		
Purchases of property and equipment	(1,071,815)	(3,198,570)
Business combinations	(2,123,591)	(470,129)
Purchases of short-term investments	--	(38,040,063)
Proceeds from sale of short-term investments	--	19,702,171
Net cash and cash equivalents used in investing activities	(3,195,406)	(22,006,591)
FINANCING ACTIVITIES		
Proceeds from sale of preferred stock, net of offering costs	9,031,393	39,737,731
Stock options exercised	68,151	329,687
Repurchase of common and preferred stock	(4,601,091)	(150,349)
Payments on notes payable	(56,171)	(426,021)
Proceeds from issuance of debt	--	--
Proceeds from issuance of convertible subordinated notes payable	5,000,000	--

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Net cash equivalents provided by financing activities	9,442,282	39,491,048
Increase/(Decrease) in cash and cash equivalents	900,730	(1,166,774)
Cash and cash equivalents, beginning of year	3,349,788	4,250,518
Cash and cash equivalents, end of year	\$ 4,250,518	\$ 3,083,744

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DataChannel, Inc.

Consolidated Statements of Cash Flows (continued)

	YEAR ENDED DECEMBER 31	
	1999	2000
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Interest paid	\$ 34,353	\$ 91,03
Income tax paid	\$ 1,600	\$ 1,60
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES		
Business acquired through issuance of common stock	\$ 100,000	\$ 246,23
Convertible subordinated notes payable converted into preferred stock	\$ --	\$5,096,84
Deferred compensation resulting from grant of stock options	\$1,011,484	\$ 338,25
Accrual of earn-out in connection with the Isogen acquisition	\$ --	\$ 600,00
Issuance of common stock in exchange for notes receivable	\$ --	\$1,870,44
Cancellation of notes receivable for common stock	\$ --	\$ --
Common stock issued for earnout in connection with Habit.com acquisition	\$ --	\$ --

See accompanying notes

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DataChannel, Inc.

Notes to Consolidated Financial Statements
(Information as of September 30, 2001 and for the nine months ended September 30, 2000 and 2001 is unaudited)

1. ORGANIZATION AND NATURE OF OPERATIONS

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DataChannel, Inc. (DataChannel or the Company) was founded in October 1996 and is a provider of enterprise portal software solutions. DataChannel's products and services enable clients to integrate their enterprise and share their information anywhere, anytime, and with anyone. DataChannel also provides complete solutions to its customers through its professional service group, which includes consulting, training, and support.

The accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. In the course of its product development and marketing activities, the Company has incurred substantial operating losses and negative cash flows from operations and expects to incur additional operating losses and negative cash flows from operations in 2001. Therefore, the Company's business will require additional equity or debt financing in order to meet its obligations through June 30, 2002.

These factors raise substantial doubt about the Company's ability to continue as a going concern. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of liabilities that might be necessary should the Company be unable to continue as a going concern. As discussed in Note 17, on October 24, 2001, the Company signed an agreement with Netegrity, Inc. ("Netegrity"), whereby Netegrity will acquire all outstanding stock of the Company. The transaction was closed on December 14, 2001.

2. SIGNIFICANT ACCOUNTING POLICIES

INTERIM FINANCIAL INFORMATION

The financial information at September 30, 2001 and for the nine months ended September 30, 2000 and 2001 is unaudited, but includes all adjustments (consisting only of normal recurring adjustments) that the Company considers necessary for a fair presentation of the financial position at such date and the operating results and cash flow for those periods. Operating results for the September 30, 2001 period are not necessarily indicative of the results that may be expected for the entire year.

USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the 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.

CONSOLIDATION

The consolidated financial statements include the accounts of DataChannel and its wholly owned subsidiaries. Significant intercompany transactions and balances have been eliminated.

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CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of highly liquid investments, including commercial paper and money market funds with maturities of 90 days or less from the date of purchase. The carrying amounts reported on the consolidated balance sheets for cash and cash equivalents approximate their fair market value.

SHORT-TERM INVESTMENTS

Short-term investments consist principally of commercial paper and demand time deposits with remaining maturities of one year or less. The Company determines the appropriate classification of its short-term investments at the time of purchase and reevaluates such designations as of each balance sheet date. All short-term investments in the Company's portfolio are classified as "available-for-sale" and are stated at fair market value. Unrealized gains and losses are reported in a separate component of shareholders' deficit. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity, and declines in value judged to be other-than-temporary are included in interest income. The cost of securities sold is based on the specific-identification method. Interest receivable on securities is included in interest income.

ACCOUNTS RECEIVABLE

Included in accounts receivable are billed amounts also included in deferred revenue of \$310,000 at December 31, 1999, and \$671,003 at December 31, 2000.

PROPERTY AND EQUIPMENT

Property and equipment consists primarily of computer-related equipment and includes leasehold improvements that are stated at cost. Depreciation is calculated on the straight-line basis over the estimated useful lives of related assets, or lease terms, if shorter. Substantially all property and equipment is depreciated over periods of three to seven years.

GOODWILL AND INTANGIBLE ASSETS

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in business acquisitions accounted for under the purchase accounting method. Other intangibles include identifiable intangible assets purchased by the Company, primarily in connection with business acquisitions. Goodwill and other intangibles are presented net of related accumulated

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
(Information as of September 30, 2001 and for the nine months ended
September 30, 2000 and 2001 is unaudited)

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

amortization and are being amortized on a straight-line basis over lives of two years. Amortization of goodwill and intangible assets was \$1,281,738 in 1999, \$1,962,911 in 2000, \$1,437,299 in the nine months ended September 30, 2000, and \$1,879,289 in the nine months ended September 30, 2001.

IMPAIRMENT OF LONG-LIVED ASSETS

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The Company evaluates impairment losses on goodwill and other long-lived assets when events and circumstances indicate that such assets might be impaired and the estimated fair value of the asset is less than its recorded amount. Conditions that would necessitate an impairment assessment include material adverse changes in operations, significant adverse differences in actual results in comparison with initial valuation forecasts prepared at the time of acquisition, a decision to abandon acquired products, services or technologies, or other significant adverse changes that would indicate the carrying amount of the recorded asset might not be recoverable. To date no such impairment charges have been made.

REVENUE RECOGNITION

The Company derives revenue from the sale of software product licenses and from professional consulting, training, maintenance, and support services.

The Company follows AICPA Statement of Position (SOP) 97-2, Software Revenue Recognition, and amendments and recognizes revenue from licensing of software products upon delivery unless the Company has significant related obligations remaining as part of the sales contract. When significant obligations remain after the software product has been shipped, revenue is deferred until such obligations have been completed or are no longer significant.

If the services are considered essential to the functionality of the software products, both the software product revenue and service revenue are recognized using the percentage-of-completion method in accordance with the provisions of SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Revenues are recognized based on the labor costs incurred to date compared to total estimated labor costs for the contract. Contract costs include all direct material, direct labor, and indirect costs related to contract performance. Provisions for estimated losses on uncompleted contracts are recorded in the period in which such losses become probable based on the current contract estimates.

Services revenue consists of fees from professional services and from maintenance and telephone support. Professional services include integration of software, application development, training, and software installation. The Company bills professional services fees either on a time-and-

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
(Information as of September 30, 2001 and for the nine months ended
September 30, 2000 and 2001 is unaudited)

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

materials or fixed-price basis. The Company recognizes professional services fees billed on a time-and-materials basis as the services are performed and recognizes professional services fees on fixed-price service arrangements on the completion of specific contractual milestone events or based on an estimated percentage of completion as work progresses.

Customers typically purchase annual maintenance agreements, which are priced based on a percentage of the current product list price and vary according to the level of support. The Company recognizes revenue from maintenance and support agreements ratably over the term of the agreement, typically one year.

The Company records cash advances from clients and billed amounts due from

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customers in excess of revenue recognized as deferred revenue. The timing and amount of cash receipts from customers can vary significantly depending on specific contract terms and can, therefore, have a significant impact on the amount of deferred revenue in any given period.

SOFTWARE DEVELOPMENT

In accordance with Statement of Financial Accounting Standards (SFAS) No. 86, Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed, the Company capitalizes eligible computer software development costs upon the establishment of technological feasibility, which it has defined as completion of a working model. For the years ended December 31, 1999 and 2000 and the nine months ended September 30, 2001, the amount of costs eligible for capitalization, after consideration of factors such as realizable value, was not material and, accordingly, all software development costs have been charged to product development expense in the accompanying consolidated statements of operations.

PRODUCT DEVELOPMENT

Product development costs are expensed as incurred and consist primarily of salaries, travel, materials, supplies, and contract services.

ADVERTISING

Advertising costs are expensed as incurred. Advertising expense was \$180,550 and \$3,659,584 for the years ended December 31, 1999 and 2000, respectively.

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
(Information as of September 30, 2001 and for the nine months ended
September 30, 2000 and 2001 is unaudited)

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

INCOME TAXES

The Company accounts for income taxes using the liability method, which recognizes the effect of temporary differences between the reporting of assets and liabilities for financial statement and income tax return purposes. A valuation allowance is provided for deferred tax assets when realization is uncertain.

STOCK-BASED COMPENSATION

The Company has elected to follow Accounting Principles Board Opinion No. 25 (APB No. 25), Accounting for Stock Issued to Employees, and related interpretations in accounting for employee stock options rather than the alternative fair value accounting allowed by Statement of Financial Accounting Standards No. 123 (SFAS No. 123), Accounting for Stock-Based Compensation. APB No. 25 provides that the compensation expense relative to the Company's employee stock options is measured based on the intrinsic value of the stock option. The Company recognizes this compensation expense using the accelerated method. SFAS No. 123 requires companies that continue to follow APB No. 25 to provide a pro forma disclosure of the impact of applying the fair value method of SFAS No. 123 (see Note 9). The Company accounts for stock issued to nonemployees in accordance with the provisions of SFAS No. 123 and the Emerging Issues Task Force consensus in Issue No. 96-18, Accounting for Equity Instruments that Are

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Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.

CONCENTRATION OF CREDIT RISK

The Company invests its cash, cash equivalents, and short-term investments with financial institutions with high credit standings and, by policy, limits the amounts invested with any one institution, type of security, and issuer.

In the year ended December 31, 2000, and nine months ended September 30, 2000, revenues to one customer represented 15% of total revenues in each period and were generated in both segments of the Company. License revenues to the customer were 29% of total license revenues for both periods. Revenues to another customer represented 10% and 12% of total revenues for the year ended December 31, 2000 and nine months ended September 30, 2000, respectively, all of which were in the services segment, representing 17% and 21%, respectively, of its revenues.

In 1999, revenues to two customers represented 20% and 13% of total revenues, respectively, all of which were in the services segment, of which they represented 32% and 21%, respectively. License revenues to another customer represented 15% of total sales and 34% of license revenues.

In the nine months ended September 30, 2001, revenues to one customer represented 13% of total revenues and were generated in both segments of the Company. License revenues to the customer were 33% of total license revenues. Revenues to two other customers each were 14% of total services revenues.

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
(Information as of September 30, 2001 and for the nine months ended
September 30, 2000 and 2001 is unaudited)

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The Company generally does not require collateral from its customers. The Company maintains allowances for potential credit losses.

FINANCIAL INSTRUMENTS

Financial instruments consist of cash and cash equivalents, short-term investments, accounts receivable and payable, accrued liabilities, convertible subordinated notes payable and notes payable. The carrying values of cash and cash equivalents, short-term investments, accounts receivable and payable, accrued liabilities and notes payable approximate their fair values based on the liquidity of these financial instruments or based on their short-term nature. The fair values of convertible subordinated notes payable are not practicable to estimate due to unique characteristics of these instruments, as described in Note 6.

RECLASSIFICATIONS

Certain prior year balances have been reclassified to conform to the current year presentation.

LOSS PER SHARE

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Basic loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the year, net of shares subject to repurchase. Diluted loss per share is computed by dividing net loss by the weighted average number of common and common equivalent shares outstanding, unless the calculation is antidilutive.

For all periods presented, the effect of dilutive securities is antidilutive. As such, the denominator used in determining loss per share is the same for both basic and dilutive loss per share.

If the Company had reported net income for the year ended December 31, 1999 and 2000 and the nine months ended September 30, 2001, diluted earnings per share would have been reduced due to the effect of common equivalent shares related to outstanding options to purchase common stock, outstanding convertible preferred stock, and outstanding warrants to purchase common stock.

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
 (Information as of September 30, 2001 and for the nine months ended
 September 30, 2000 and 2001 is unaudited)

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

LOSS PER SHARE (CONTINUED)

The following represents the reconciliation between the weighted-average number of shares of common stock outstanding and the number of shares of common stock used for basic and diluted loss per share computations:

	YEAR ENDED DECEMBER 31		NINE MONTHS ENDED SEPTEMBER 30	
	1999	2000	2000	2001
			(unaudited)	(unaudited)
Weighted-average number of shares outstanding	9,705,031	14,186,218	14,053,980	14,196,4
Weighted average number of common shares issued subject to repurchase agreements	-	(3,596,252)	(3,544,132)	(1,775,2
Shares used in computation of basic and diluted net loss per share	9,705,031	10,589,966	10,509,848	12,421,1

3. SHORT-TERM INVESTMENTS

Short-term investments consist of available-for-sale debt securities that are carried at fair value. Unrealized gains and losses on short-term investments represent the difference between the fair market value and the amortized cost. The following is a summary by major security type of the Company's short-term investments:

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December 31, 2000	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	ESTIMATED FAIR VALUE
Commercial paper	\$ 6,913,195	\$ --	\$ (5,835)	\$ 6,907,360
U.S. government securities	1,006,355	1,828	--	1,008,183
Corporate securities	10,418,341	15,199	--	10,433,540
	\$ 18,337,891	\$ 17,027	\$ (5,835)	\$ 18,349,083

At December 31, 2000, the securities available-for-sale had contractual maturities through August 2001. Gross realized gains and losses on sales of investments are immaterial during the year ended December 31, 2000.

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
(Information as of September 30, 2001 and for the nine months ended
September 30, 2000 and 2001 is unaudited)

4. BUSINESS COMBINATIONS

ACQUISITION OF ISOGEN

On April 12, 1999, DataChannel entered into a Stock Purchase Agreement with Isogen, a professional services organization located in Dallas, Texas, under which the Company agreed to purchase all of the outstanding capital shares of Isogen for a total purchase price of \$4,226,528, including 500,000 shares of the Company's common stock with a fair value of \$100,000 (common stock at \$0.20 per share), \$4.0 million in cash, and acquisition costs of \$126,528. Of the \$4.0 million in cash, \$2 million was paid in 1999 and \$1.4 million was paid subsequent to December 31, 2000, and is recorded as a short-term note payable at December 31, 2000. Included in the transaction also was \$600,000 earn-out bonus, which was contingent on Isogen achieving certain financial goals by December 31, 2000. On January 31, 2001, the Company paid out the earn-out bonus of \$600,000 to the principals of Isogen based on the achievement of the financial goals set forth in the Isogen Stock Purchase Agreement. The earn-out bonus was allocated to goodwill and will be amortized over the remaining life of the goodwill.

The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase price of the acquisition was allocated to assets, goodwill, and liabilities assumed on the basis of their fair values. The Company's consolidated statements of operations and cash flows for the year ended December 31, 1999 include the operations of Isogen since April 12, 1999.

ACQUISITION OF HABIT.COM

On November 30, 2000, the Company acquired Habit.com, a Seattle-based software company, in exchange for 223,848 shares of its common stock. The aggregate purchase price of the acquired company was \$316,362. In addition, the Company issued one share of Series X Junior Preferred and one share of Series Y Junior Preferred. If certain technical milestones are met within specified dates, the Series X and Y Junior Preferred shares will each convert into 490,001 shares of common stock and 980,002 in the aggregate. The Company's consolidated statements of operations and cash flows for the year ended December 31, 2000 include the

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operations of Habit.com since November 30, 2000. The transaction was accounted for using the purchase method of accounting. Accordingly, the purchase price of the acquisition was allocated to goodwill.

In connection with the Habit.com acquisition, the Company entered into a noncompete agreement with two principal founders of Habit.com. Consideration for the noncompete agreement of \$400,000 was paid in cash and will be amortized over its life of two years.

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
(Information as of September 30, 2001 and for the nine months ended
September 30, 2000 and 2001 is unaudited)

4. BUSINESS COMBINATIONS (CONTINUED)

On February 28, 2001 and March 23, 2001, the Company converted and issued one share of Series X Junior Preferred stock into 490,001 shares of common stock and one share of Series Y Junior Preferred stock into 490,001 shares of common stock to the shareholders of Habit.com for achieving certain technical milestones. The value of these shares, which approximates \$1,078,000, was allocated to goodwill and will be amortized over its estimated useful life of 2 years.

A summary of the purchase price for the acquisitions as of December 31, 2000 is as follows:

	ISOGEN	HABIT.COM
	-----	-----
Common stock	\$ 100,000	\$ 246,233
Cash paid to shareholders	2,000,000	400,000
Notes and bonus payable to shareholders	2,000,000	--
Accrued acquisition costs	126,528	70,129
	-----	-----
	\$4,226,528	\$ 716,362
	=====	=====

The purchase price was allocated as follows as of December 31, 2000:

	ISOGEN	HABIT.COM
	-----	-----
Estimated fair values:		
Assets acquired	\$ 868,297	\$ 400,000
Liabilities assumed	(941,220)	--
Goodwill	4,299,451	316,362
	-----	-----
Purchase price	\$ 4,226,528	\$ 716,362
	=====	=====

The following unaudited pro forma summarized results of operations assume that

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the Company's acquisitions of Isogen occurred as of January 1, 1999 and Habit.com occurred as of January 1, 1999 and 2000:

	YEAR ENDED DECEMBER 31	
	1999	2000
Pro forma total revenue	\$ 7,945,652	\$ 14,548,942
Pro forma net loss	\$ (9,661,906)	\$ (29,793,007)
Pro forma basic and diluted loss per share	\$ (0.96)	\$ (2.76)

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
 (Information as of September 30, 2001 and for the nine months ended
 September 30, 2000 and 2001 is unaudited)

4. BUSINESS COMBINATIONS (CONTINUED)

The unaudited pro forma results do not purport to be indicative of the results of operations which actually would have resulted had the acquisitions occurred on January 1, 1999 and 2000, nor are they necessarily indicative of future operating results.

5. PROPERTY AND EQUIPMENT

Property and equipment was as follows:

	DECEMBER 31		SEPTEMBER 30
	1999	2000	2001
			(Unaudited)
Computers and office equipment	\$ 1,456,361	\$ 3,604,313	\$ 3,939,126
Software	216,125	614,386	596,108
Furniture and fixtures	149,160	424,261	470,078
Leasehold improvements	20,587	453,981	544,845
	1,842,233	5,096,941	5,550,157
Less accumulated depreciation	(637,381)	(1,713,421)	(2,809,783)
Property and equipment, net	\$ 1,204,852	\$ 3,383,520	\$ 2,740,374

Depreciation expense was \$461,294 and \$1,076,040 for the years ended December 31, 1999 and 2000, respectively, and \$722,241 and \$1,096,362 for the nine months ended September 30, 2000 and 2001, respectively.

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
 (Information as of September 30, 2001 and for the nine months ended
 September 30, 2000 and 2001 is unaudited)

6. NOTES PAYABLE

Notes payable consist of the following:

	DECEMBER 31	
	1999	2000
Non-interest bearing note payable to the founders of Isogen, repaid in 2001	\$1,400,000	\$1,400,000
Note payable to a bank	--	--
Notes payable to Bank of the West. The notes were repaid in 2000	411,740	--
Other	15,932	57,789
Total debt	1,827,672	1,457,789
Less current portion	(12,215)	(1,416,812)
Long-term portion	\$1,815,457	\$ 40,977

In January 2001, the Company entered into a loan agreement with a bank to borrow \$3,500,000 under a revolving line of credit (Line) to support working capital requirements and \$4,000,000 under a term loan (Term) to purchase capital equipment. The Line carries an interest rate equivalent to the bank's prime rate and is payable at maturity, which is January 2002. The Term carries an interest rate of the bank's prime rate plus 0.75% and is payable in 30 equal monthly installments through January 2004. Both loans are collateralized by substantially all of the Company's assets. In connection with the loan, the Company issued warrants to purchase 18,771 shares of common stock at \$5.59 per share. The value of the warrants of \$20,648 is being amortized to interest expense over the term of the agreement. The Company must comply with certain covenants under this arrangement, including liquidity ratios.

Maturities of notes payable as of December 31, 2000 are as follows:

2001	\$ 1,416,812
2002	31,218
2003	9,759

	\$ 1,457,789
	=====

CONVERTIBLE SUBORDINATED NOTES PAYABLE

In December 1999, the Company issued convertible promissory notes to two

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investors in the amount of \$2.5 million each (\$5 million in the aggregate). The notes were unsecured and accrued interest at the rate of 7% per annum. Principal and interest were due on June 8, 2000. The unpaid principal balance and accrued interest of \$5,096,845 was converted into 911,176 shares of the Company's Series D in March 2000 at a conversion price of \$5.59 per share (see Note 7).

On the date of the preferred stock issuance, the effective conversion price of the convertible debt (after allocating the portion of proceeds to the preferred stock warrants, based on relative fair values) was at a discount to the price of the preferred stock into which the convertible debt was convertible. The discount of \$500,563 associated with the beneficial conversion was recorded as interest expense.

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
 (Information as of September 30, 2001 and for the nine months ended
 September 30, 2000 and 2001 is unaudited)

6. NOTES PAYABLE (CONTINUED)

In connection with the convertible notes issuance in March 2000, the Company issued a total of 455,588 warrants to purchase shares of common stock at an exercise price of \$0.001 per share. The estimated fair value of the warrants of \$501,146 was computed using the Black-Scholes valuation method and the following assumptions: 10-year expected life; no dividend yield; risk-free interest rate of 6.92%; and volatility of 100%. The fair value of the warrants was recorded as interest expense.

At December 31, 2000, all warrants remain outstanding. The warrants expire ten-years from the date of issue.

7. CONVERTIBLE PREFERRED STOCK

The Company has authorized 14,977,838 shares of convertible preferred stock. The Board of Directors has the authority to establish and define, in one or more series, the price, rights, preferences, and dividends of authorized but unissued shares of preferred stock.

Preferred stock consisted of the following at

	December 31	
	1999	2000

Series A:		
1,784,143 shares authorized, 1,784,143 issued and outstanding in 1999, 2000 and 2001	\$ 783,874	\$ 783,874
Series B:		
2,366,496 shares authorized, 2,366,496 shares issued and outstanding in 1999, 2000 and 2001	2,479,777	2,479,777
Series C:		
2,782,434 shares authorized, 2,703,105 issued and outstanding in 1999, 2000 and 2001	9,031,393	9,031,393
Series D:		
8,044,765 shares authorized, 8,044,765		

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issued and outstanding in 2000 and 2001	--	44,834,576
Junior X:		
1 share authorized, 1 issued and outstanding in 2000 and 0 in 2001	--	--
Junior Y:		
1 share authorized, 1 issued and outstanding in 2000 and 0 in 2001	--	--
	-----	-----
	\$12,295,044	\$57,129,620
	=====	=====

DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
 (Information as of September 30, 2001 and for the nine months ended
 September 30, 2000 and 2001 is unaudited)

7. CONVERTIBLE PREFERRED STOCK (CONTINUED)

During 2000, the Company completed a private offering of 8,044,765 shares of Series D at \$5.59 per share or \$39,903,156 in cash and conversion of convertible notes and accrued interest of \$5,096,845. Related offering costs were \$165,425.

The rights and preferences of the convertible preferred stock are as follows:

DIVIDENDS

Dividends are noncumulative and declared only by resolution of the Company's Board of Directors.

LIQUIDATION PREFERENCE

According to the Company's Articles of Incorporation, a liquidation event includes any dissolution or winding up of the Company, a sale of substantially all of the assets of the Company or a merger, consolidation or statutory share exchange in which the Company's shareholders do not continue to own at least 50% of the voting power of the surviving entity. Accordingly, the convertible preferred stock has been classified outside of permanent equity. Upon a liquidation event, the holders of Series D convertible preferred stock will be entitled to receive \$5.59 per share, holders of Series C convertible preferred stock would be entitled to receive \$3.34 per share, and holders of Series B convertible preferred stock would be entitled to receive \$1.07 per share, plus any declared but unpaid dividends, prior and in preference to any distribution to the holders of Series A convertible preferred stock or common stock. After the distribution to Series B and C shareholders, the Series A shareholders would be entitled to receive \$0.70 per share, plus any declared but unpaid dividends, prior and in preference to any distribution to the holders of common stock. Assets will then be ratably distributed to holders of Series A, B, C, D, and common stock on an as-if-converted common basis.

Each share of series X Junior preferred stock and Series Y Junior preferred stock is subordinated to all other shares of preferred stock of the Company. For liquidation purposes, each share of Series X and Series Y will be treated as if those shares had been converted into the number of shares of common stock to which they would then have equivalent voting rights.

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
(Information as of September 30, 2001 and for the nine months ended
September 30, 2000 and 2001 is unaudited)

7. CONVERTIBLE PREFERRED (CONTINUED)

CONVERSION

Each share of convertible preferred stock is convertible at the option of the holder into common stock at the conversion price in effect at such date.

Upon the earlier of (a) the closing of an initial public offering that meets certain conditions or (b) the conversion of a majority of Series B, C, and D stock into common stock, all outstanding convertible preferred stock will automatically convert into shares of common stock at the conversion price in effect on such date.

VOTING RIGHTS

Each holder of convertible preferred stock shall be entitled to the number of votes equal to the number of shares of common stock on an as-if-converted common basis.

8. SHAREHOLDERS' DEFICIT

COMMON STOCK WARRANTS

On December 2, 1999, the Company issued warrants to purchase 15,000 shares of common stock, in exchange for services, at an exercise price of \$0.60 per share, which will vest over 5 years and will expire on December 2, 2009. The fair value of these warrants, determined using a Black Scholes valuation option pricing model, was not material.

During July 2000, warrants for 50,000 shares of common stock at an exercise price of \$5.60 per share were issued in connection with a commercial relationship agreement. These warrants were fully vested when issued, expire on May 1, 2006, and were valued at the fair value of \$58,566 using a Black-Scholes valuation option pricing model. In this connection, the Company recorded this amount as stock-based compensation expense during 2000. All of the warrants remain outstanding at December 31, 2000.

NONEMPLOYEE STOCK OPTIONS

During 2000, the Company also issued stock options to purchase 80,000 shares of common stock ranging from \$0.20 to \$1.10 per share to consultants, which vest over the service periods ranging from zero to five years. The Company recognized stock-based compensation expense of \$78,624 related to these equity awards. No shares were exercised at December 31, 2000.

DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
(Information as of September 30, 2001 and for the nine months ended
September 30, 2000 and 2001 is unaudited)

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8. SHAREHOLDERS' DEFICIT (CONTINUED)

NOTE RECEIVABLE FROM OFFICERS

During January 2000, the Company entered into an agreement with six officers to exercise certain options (vested and unvested) in exchange for cash and promissory notes. The Company has the right to repurchase certain of these shares, at original issue price for vested shares, in the event the holder's relationship with the Company terminates. The repurchase rights do not have an expiration date. At December 31, 2000, 4,210,944 common shares were subject to repurchase.

In connection with the exercise of these options, the officers elected to have the Company carry notes for up to 91% of the purchase price, totaling \$1,870,448. The notes bear interest at 6.21% per annum. The Company recorded a \$801,244 non-cash compensation charge related to this transaction, while simultaneously increasing the balance of common stock. During the nine month period ended September 30, 2001, as the fair value of the Company's common stock decreased to \$0.19 per share, accordingly, all of the above compensation expense was reversed and credited to the statement of operations.

In February and March 2001, the Company repurchased and retired 2,433,148 shares of the restricted common stock at original issue price from three officers who terminated their employment. As a result, certain notes were retired totaling \$1,489,890.

STOCK REPURCHASE AGREEMENT

In 1999, the Company agreed to grant to an officer nonqualified options to purchase 1,503,494 shares of common stock. In connection, the Company also entered into a stock repurchase agreement with the founder to repurchase from the founder the number of shares equal to one-half of the shares of common stock issued and exercised by the officer. The amount of shares to be repurchased from the founder is not to exceed 751,747 shares, and the repurchase price will be equal to the exercise price of the stock options issued to the officer.

In March 2000, the Company purchased 751,747 shares of the Company's common stock from the founder at \$0.20 per share as a result of the officer exercising 1,202,795 shares. The agreement permits the founder to repurchase the shares in the event the Company has the right to repurchase any unvested shares from the officer.

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
(Information as of September 30, 2001 and for the nine months ended
September 30, 2000 and 2001 is unaudited)

8. SHAREHOLDERS' DEFICIT (CONTINUED)

SHARES RESERVED

A summary of common stock reserved for issuance as of December 31, 2000 is as follows:

SHARES

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Conversion of Series A preferred stock	1,784,143
Conversion of Series B preferred stock	2,366,496
Conversion of Series C preferred stock	2,782,434
Conversion of Series D preferred stock	8,044,765
Series X junior preferred stock	490,001
Series Y junior preferred stock	490,001
Warrants	570,588
Stock options:	
Outstanding	7,384,504
Available for future grants	6,134,960

	30,047,892
	=====

9. STOCK OPTION PLAN

In June 1997, the Company adopted the 1997 Stock Option Plan (the Plan). Under the terms of the Plan, nonqualified stock options may be granted to employees, directors, officers, and consultants at a price determined by the Board of Directors. Options have a term of up to ten years and vest over a schedule determined by the Board of Directors, generally five years. The Board of Directors amended the vesting term retroactively from five years to four years in February 2000. Incentive stock options granted under this program may only be granted to employees of the Company, have a term of up to ten years, and shall be granted at a price equal to the fair market value of the Company's stock on the date of grant.

Also, in May 2000, the Company adopted the 2000 Non-employee Director Stock Option Plan, which grants new members of the Board of Directors a non-statutory stock option to purchase 50,000 shares of common stock and all Board members an additional 10,000 shares at each annual Board of Directors meeting for their year of service. The Company reserved 200,000 shares of common stock for this plan. The exercise price is at fairmarket value on the date of grant. The 50,000 stock options vest 25% after the first year, and 1/48th of the total option for each month beyond the first year, and the additional 10,000 vest immediately upon grant. The occurrence of any change in control will cause all outstanding stock options to become immediately and fully exercisable and vested.

DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
 (Information as of September 30, 2001 and for the nine months ended
 September 30, 2000 and 2001 is unaudited)

9. STOCK OPTION PLAN (CONTINUED)

The Company applies APB No. 25 and related interpretations in accounting for its stock option plan. Accordingly, \$1,150,756 and \$548,382 in compensation costs were recognized in the accompanying financial statements for stock options granted to employees in 2000 and 1999, respectively, because the fair value of the underlying common stock on the date of grant was greater than the exercise price of the stock options granted. During the nine months ended September 30, 2001, as the fair value of the Company's common stock reduced, \$801,244 of the above compensation expense was reversed and credited to the statement of operations. Total net credit for compensation expense to employees was \$595,988 during the nine months ended September 30, 2001.

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SFAS No. 123 requires pro forma disclosure of net income as if the fair value method were used. The fair value of each option grant is estimated on the date of grant using the minimum value option-pricing model with the following weighted-average assumptions: risk-free interest rate of 5.93% and 5.5% in 2000 and 1999, respectively; expected life of 4 years and expected dividend yields of 0%. Had the stock compensation expense for the Company's stock option plan been determined based on the fair value at the grant dates for options granted during the year, consistent with the fair value method of SFAS No. 123, the Company's net loss would have been increased to the following pro forma amount:

	1999 ----	2000 ----
Net loss as reported	\$ (8,848,277)	\$ (28,283,951)
Pro forma net loss under SFAS No. 123	\$ (8,940,991)	\$ (28,814,370)
Basic and diluted loss per share as reported	\$ (0.91)	\$ (2.79)
Pro forma basic and diluted loss per share	\$ (0.92)	\$ (2.84)

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
(Information as of September 30, 2001 and for the nine months ended
September 30, 2000 and 2001 is unaudited)

9. STOCK OPTION PLAN (CONTINUED)

Option activity under the plan was as follows:

	OPTIONS OUTSTANDING -----	WEIGHTED- AVERAGE EXERCISE PRICE -----
Balances at January 1, 1999	3,518,994	\$0.17
Granted at fair market value	2,296,350	\$0.23
Granted below fair market value	3,517,649	\$0.60
Exercised	(381,898)	\$0.18
Terminated/canceled	(893,001)	\$0.19

Balances, December 31, 1999	8,058,094	\$0.39
Granted at fair market value	4,347,412	\$1.02
Granted below fair market value	733,500	\$0.60
Exercised	(5,091,319)	\$0.43
Terminated/canceled	(663,183)	\$0.59

Balances at December 31, 2000	7,384,504	\$0.77
	=====	

As of December 31, 1999 and 2000, 1,731,383 and 1,062,290 options, respectively, were exercisable, with weighted-average exercise prices of \$0.39 and \$0.29, respectively.

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segments:							
Software	\$ 2,776,039	\$ 2,616,495	\$ 5,975,239	\$ 5,098,011	\$ 4,672,633	\$3,932,191	\$
Services	4,624,007	2,052,591	8,573,703	1,933,523	5,952,827	1,123,343	
Totals	\$ 7,400,046	\$ 4,669,086	\$14,548,942	\$ 7,031,534	\$10,625,460	\$5,055,534	\$

The Company does not review any other financial information for these reportable segments. Revenue generated from foreign operations was immaterial for the years ended December 31, 1999 and 2000 and for the nine months ended September 30, 2000 and 2001.

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
 (Information as of September 30, 2001 and for the nine months ended
 September 30, 2000 and 2001 is unaudited)

11. INCOME TAXES

At December 31, 2000, the Company had a net operating loss carryforward and research and development credits of approximately \$34,232,000 and \$484,000, respectively, which are available to offset future federal taxable income and expire between 2011 and 2020. The Company's ability to utilize net operating loss carryforwards may be limited in the event that a change in ownership, as defined in the Internal Revenue Code, occurs in the future. To the extent that any single-year loss is not utilized to the full amount of the limitation, such unused loss is carried forward to subsequent years until the earlier of its utilization or the expiration of the relevant carryforward period. To the extent that net operating losses, when realized, relate to stock option deductions of approximately \$988,000, the resulting benefits will be credited to shareholders' equity. A valuation allowance has been recognized to offset the related deferred tax assets due to the uncertainty of realizing the benefit of the Company's net operating loss carryforward. While the need for this allowance is subject to periodic review, the tax benefits of the carryforward will be recorded when recognized as a reduction of the Company's income tax expense.

The Company's valuation allowance increased approximately \$2,800,000 and \$9,200,000 in 1999 and 2000, respectively, primarily due to net operating losses incurred during these periods.

Significant components of the Company's deferred tax assets are as follows:

	DECEMBER 31	
	1999	2000
Deferred tax assets:		
Net operating loss carryforward	\$ 3,024,769	\$ 11,638,912
Research and development tax credits	202,166	164,502
Other	386,221	931,845
	3,613,156	12,735,259

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Less valuation allowance	(3,613,156)	(12,735,259)
	-----	-----
Net deferred tax assets	\$ --	\$ --
	=====	=====

12. COMMITMENTS

The Company leases its office facilities under operating leases with expiration dates through April 2004. The leases generally require the Company to maintain the property and contain certain renewal options for varying periods.

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
 (Information as of September 30, 2001 and for the nine months ended
 September 30, 2000 and 2001 is unaudited)

12. COMMITMENTS (CONTINUED)

Future minimum lease commitments under noncancelable leases as of December 31, 2000 are as follows:

2001	\$1,559,497
2002	1,580,896
2003	1,620,667
2004	615,698
Thereafter	49,176

Total minimum lease payments	\$5,425,934
	=====

Rent expense under operating leases totaled \$562,663 and \$1,150,854, net of sublease rentals of approximately \$148,432 and \$397,170, for the years ended December 31, 1999 and 2000, respectively.

13. 401(K) RETIREMENT PLAN

The Company has a retirement savings plan covering substantially all eligible employees. This 401(k) plan provides for a discretionary matching contribution by the Company, limited to eligible contributions by the employees. The Company did not contribute or accrue amounts in 1999 and 2000.

14. RELATED-PARTY TRANSACTIONS

During the years ended December 31, 1999 and 2000, the CEO received no cash compensation for services rendered. In 2000, the Company made payments of \$79,000 for services rendered to a company in which Isogen's former owners have an equity interest.

During 2000, the Company sold approximately \$1,800,000, \$225,000, and \$250,000 of software and services to three entities that were related to or affiliated with the Company's Series D shareholders.

15. CONTINGENCIES

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Various claims and legal proceedings relating to former employees are pending against the Company. Management believes that all of these claims and proceedings are without merit or otherwise will not have a material adverse impact on the Company's consolidated financial position, liquidity or results of operations.

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DataChannel, Inc.

Notes to Consolidated Financial Statements (continued)
(Information as of September 30, 2001 and for the nine months ended
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16. SUBSEQUENT EVENTS - (UNAUDITED)

On October 24, 2001, the Company signed a definitive agreement with Netegrity, Inc. (Netegrity), whereby Netegrity will acquire all outstanding stock of the Company. The consideration for the acquisition is approximately \$15 million in cash and 2.5 million in common shares. The transaction was closed on December 14, 2001.

On November 30, 2001, the Company entered into an agreement to sell all the identified assets relating to their professional services business unit for \$1.3 million. The assets had a net book value of \$1.15 million as of the purchase date. The purchaser paid the Company \$650,000 on November 30, 2001 with \$325,000 due on April 30, 2002 and \$325,000 due on September 31, 2002. The purchaser assumed all liabilities, including customer obligations, of the business unit sold and hired its employees.

In November 2001, the company was advanced \$1,000,000 from Netegrity. The advance was forgiven upon consummation of the business combination.

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Item 7.(b)

UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL INFORMATION OF NETEGRITY, INC.

The following unaudited pro forma financial statements of Netegrity give effect to the acquisition of DataChannel by Netegrity as if it had occurred on September 30, 2001 with respect to the pro forma balance sheet and as if it had occurred on January 1, 2000 with respect to the unaudited pro forma statements of operations.

Pursuant to the terms of the definitive merger agreement, Netegrity acquired DataChannel for 2,499,968 shares of Netegrity common stock and cash payments of \$16,087,000, assumed debt of \$1,440,000 and estimated transaction cost of \$2,970,000, for a total purchase price of \$70,196,000.

The pro forma financial statements utilize the purchase method of accounting for the merger of Netegrity and DataChannel. Netegrity is the acquiring company for accounting purposes. Under the purchase method of accounting, the purchase price is allocated to assets acquired and liabilities assumed based on their estimated fair value at the time of the merger. The results of operations of DataChannel will be included in the results of operations of the combined company from December 14, 2001 (the date of the

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acquisition). The pro forma condensed consolidated financial statements reflect the preliminary purchase price allocation based on the Company's best estimate of the fair value of the assets to be acquired and the liabilities to be assumed. The Company does not expect the final purchase price allocation to be materially different.

The Company engaged a third party appraiser to conduct a valuation of the intangible assets and to assist in the determination of useful lives for such assets. Based on the appraisal, approximately \$11,000,000 of the purchase price has been allocated to developed technology and \$3,000,000 has been allocated to in-process research and development, which was expensed upon closing of the transaction. Due to the non-recurring nature of the in-process research and development charge, the amount has not been included in the pro forma statement of operations. The amount allocated to developed technology is expected to be amortized over its estimated useful life of 3 years.

The valuation of in-process research and development was determined using the income method. Revenue and expense projections for the in-process research and development project were prepared by management. The value was determined using the present value of the cash flows from the projections using a 32.5% discount rate. The technologies under development were approximately 50% complete based on project duration and costs. In the event that the project is not completed and technological feasibility is not achieved, there is no alternative future use for the in-process technology. The assumptions used for the valuation of the in-process research and development are the responsibility of management and are subject to change.

In accordance with recently issued Statement of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets," the goodwill resulting from the acquisition of DataChannel will not be amortized but rather will be tested at least annually for impairment.

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The pro forma condensed consolidated financial data is for information purposes only and is not necessarily indicative of the results of future operations of the combined company or the actual results that would have been achieved had the merger of Netegrity and DataChannel been consummated during the periods indicated. You should read the unaudited pro forma financial data in conjunction with the consolidated historical financial statements of Netegrity and DataChannel, including the notes to all sets of financial statements.

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\UNAUDITED PRO FORMA CONDENSED
COMBINED BALANCE SHEET
AS OF SEPTEMBER 30, 2001

	HISTORICAL		DATACHANNEL	DATACHANNEL
	NETEGRITY	DATACHANNEL	ADJUSTMENTS	ADJUSTED
	-----	-----	-----	-----
Current Assets:				
Cash and cash equivalents	\$51,202,000	\$2,756,000		\$2,756,000
Marketable securities	55,019,000	-		
Accounts receivable-trade, net	15,984,000	2,400,000	(1,447,000) (4)	953,000
Prepaid expenses and other				

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current assets	1,918,000	870,000		870,000
	-----	-----		-----
Total Current Assets	124,123,000	6,026,000		4,579,000
Property and equipment, net	6,821,000	2,740,000	(87,000) (4)	2,653,000
Intangible assets	-	970,000		970,000
Long-term marketable securities	20,298,000	-		
Restricted cash	626,000	-		
Other assets	219,000	105,000	(7,000) (4)	98,000
	-----	-----		-----
Total Assets	\$152,087,000	\$9,841,000		\$8,300,000
	=====	=====		=====
Current Liabilities:				
Accounts payable	1,210,000	1,971,000	(59,000) (4)	1,912,000
Accrued compensation and benefits	4,723,000	-		
Other accrued expenses	6,461,000	1,080,000	(141,000) (4)	939,000
Deferred revenue	11,190,000	3,259,000	(207,000) (4)	3,052,000
Current portion notes payable	-	713,000		713,000
	-----	-----		-----
Total Current Liabilities	23,584,000	7,023,000		6,616,000
Notes payable	-	910,000		910,000
Preferred Stock	-	57,130,000		57,130,000
Stockholders Equity:				
Common stock	312,000	5,007,000		5,007,000
Additional paid-in-capital	146,442,000	-		
Deferred stock compensation	-	(154,000)		(154,000)
Notes receivable on restricted stock	-	(381,000)		(381,000)
Loan to officer	(130,000)	-		
Accumulated other comprehensive income	(20,000)	-		
Accumulated deficit	(18,017,000)	(59,694,000)	(1,134,000) (4)	(60,828,000)
	-----	-----		-----
	128,587,000	(55,222,000)		(56,356,000)
Less - Treasury stock, at cost	(84,000)	-		
	-----	-----		-----
Total Stockholders Equity	128,503,000	(55,222,000)		(56,356,000)
	-----	-----		-----
Total Liabilities and Stockholders' Equity	\$152,087,000	\$9,841,000		\$8,300,000
	=====	=====		=====

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UNAUDITED PRO FORMA CONDENSED
COMBINED STATEMENT OF OPERATIONS
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2001

	HISTORICAL -----			
	NETEGRITY -----	DATACHANNEL -----	DATACHANNEL ADJUSTMENTS -----	DATACHANNEL ADJUSTED -----
Revenues:				
License software	\$43,842,000	\$3,676,000		\$3,676,000
Services	20,887,000	8,588,000	(4,975,000) (4)	3,613,000
Other	2,772,000	-		-
	-----	-----		-----
Total revenues	67,501,000	12,264,000		7,289,000
Cost of Revenues				
Cost of license software	1,503,000	213,000		213,000
Cost of services	10,675,000	5,957,000	(2,855,000) (4)	3,102,000
Cost of other	1,671,000	-		-
	-----	-----		-----
	13,849,000	6,170,000		3,315,000
	-----	-----		-----
Gross profit	53,652,000	6,094,000		3,974,000
Selling, general and administrative expenses				
Selling, general and administrative expenses	40,617,000	14,299,000	(230,000) (4)	14,069,000
Research and development expenses	11,865,000	8,617,000		8,617,000
Non recurring expenses	603,000			
Amortization of intangible assets	-	1,879,000		1,879,000
	-----	-----		-----
Total operating expenses	53,085,000	24,795,000		24,565,000
Income (loss) from operations	567,000	(18,701,000)		(20,591,000)
Interest income	4,098,000	444,000		444,000
Interest expense	-	(89,000)		(89,000)
	-----	-----		-----
Income (loss) before provision for income taxes	4,665,000	(18,346,000)		(20,236,000)
Provision for income taxes	607,000	-		-
	-----	-----		-----
Net income (loss)	\$4,058,000	\$ (18,346,000)		\$ (20,236,000)
	=====	=====		=====
Basic net income (loss) per share attributable to common stockholders:	\$0.13	N/A		N/A
	=====			
Basic weighted average shares outstanding	30,850,000	N/A		N/A

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	=====		
Diluted net income (loss) per share attributable to common stockholders:	\$0.12	N/A	N/A
	=====		
Diluted weighted average shares outstanding	32,962,000	N/A	N/A
	=====		

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UNAUDITED PRO FORMA CONDENSED
COMBINED STATEMENT OF OPERATIONS
FOR THE TWELVE MONTHS ENDED DECEMBER 31, 2000

	HISTORICAL			
	NETEGRITY	DATACHANNEL	DATACHANNEL ADJUSTMENTS	DATACHANNEL ADJUSTED
	-----	-----	-----	-----
Revenues:				
License software	37,688,000	\$5,975,000		\$5,975,000
Services	12,693,000	8,574,000	(6,328,000) (4)	2,246,000
Other	3,655,000	-		-
	-----	-----		-----
Total revenues	54,036,000	14,549,000		8,221,000
Cost of Revenues				
Cost of license software	2,549,000	877,000		877,000
Cost of services	7,415,000	6,640,000	(4,272,000) (4)	2,368,000
Cost of other	2,169,000	-		-
	-----	-----		-----
Total cost of revenues	12,133,000	7,517,000		3,245,000
Gross profit	41,903,000	7,032,000		4,976,000
Selling, general and administrative expenses	36,094,000	24,244,000	(582,000) (4) 302,000 (6)	23,964,000
Research and development expenses	9,103,000	9,532,000	1,208,000 (6)	10,740,000
Amortization of intangible assets	-	1,963,000		1,963,000
	-----	-----		-----
Total operating expenses	45,197,000	35,739,000		36,667,000
Income (loss) from operations	(3,294,000)	(28,707,000)		(31,691,000)
Interest income	6,103,000	1,590,000		1,590,000
Interest expense	-	(1,167,000)		(1,167,000)
Other expense, net	-	-		-

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Income (loss) before provision for income taxes	2,809,000	(28,284,000)	(31,268,000)
Provision for income taxes	75,000	-	-
Net income (loss)	<u>\$2,734,000</u>	<u>\$ (28,284,000)</u>	<u>\$ (31,268,000)</u>
Basic net income (loss) per share attributable to common stockholders:	\$0.09	N/A	N/A
Basic weighted average shares outstanding	<u>29,010,000</u>	N/A	N/A
Diluted net income (loss) per share attributable to common stockholders:	\$0.08	N/A	N/A
Diluted weighted average shares outstanding	<u>33,407,000</u>	N/A	N/A

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NOTES TO UNAUDITED PRO FORMA CONDENSED
COMBINED FINANCIAL STATEMENTS

1. To record a) the issuance of 2,499,968 shares of Netegrity common stock and the cash payment of \$16,087,000 to the stockholders of DataChannel, b) the allocation of the purchase price to the assumed fair value of the identifiable assets acquired and liabilities assumed and c) the elimination of the equity accounts of DataChannel. The fair market value of the common stock has been valued at \$19.88 per share based on the average fair value of the common stock for two days before and after the closing of the transaction. The allocation of the purchase price to the assumed fair value of the identifiable assets acquired and liabilities assumed was calculated as follows:

Consideration Exchanged:

Fair value of shares issued to DataChannel stockholders (2,499,968 shares at \$19.88)	\$49,699,000
Cash paid to DataChannel stockholders	16,087,000

Liabilities Assumed:

Notes payable	1,440,000
---------------	-----------

Total consideration exchanged 67,226,000

Estimated transaction costs 2,970,000

Total purchase price 70,196,000

Less fair value of the net tangible assets,
liabilities assumed, and identifiable intangible assets

Net tangible assets	1,060,000
Restructuring reserve	(2,124,000)

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Developed technology	11,000,000
In process research and development	3,000,000

Excess of purchase price over net tangible assets, liabilities assumed and identifiable intangible assets	\$57,260,000

(Goodwill)	

The restructuring reserve consists of severance costs of approximately \$290,000 related to duplicative functions, as well as excess facility costs of approximately \$1,834,000 which will be recorded in accordance with Emerging Issue Task Force Consensus 95-3.

At the date of the acquisition, DataChannel had a tax net operating loss carryforward of \$54,923,000 (resulting in a deferred tax asset of \$21,970,000). Due in part to the fact the net operating loss carryforward will be subject to an annual limitation in its usage by Netegrity of approximately \$3,100,000, Netegrity has provided a valuation allowance of \$17,700,000 against this deferred tax asset in connection with the purchase price allocation. To the extent the valuation allowance is reduced in future periods, any reduction will be recorded as a decrease to goodwill.

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2. To record the amortization of the fair value of the developed technology acquired in the transaction. Netegrity has estimated the acquired developed technology has a 3-year useful life.
3. To eliminate historical interest income earned on the cash paid to DataChannel.
4. To remove the assets and liabilities as of September 30, 2001 and results of operations for the nine months ended September 30, 2001 and the year ended December 30, 2000, of the Isogen division. The Isogen business was divested by DataChannel prior to the completion of the acquisition.
5. To reflect the issuance of the 2,499,968 shares of Netegrity common stock as of January 1, 2000 and eliminate the antidilutive impact of the common stock equivalents.
6. To include the results of operations of Habit.com in the consolidated DataChannel results of operations for the period prior to completion of the acquisition of Habit.com which was acquired by DataChannel in November 2000.
7. To reverse the goodwill recorded by DataChannel related to the acquisition of Habit.com and the related amortization expense.
8. To adjust the net assets of DataChannel to the net assets at December 14, 2001, the date of the acquisition.
9. To adjust deferred revenue to fair value as of the acquisition date.

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SIGNATURE

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

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Date: February 11, 2002

NETEGRITY, INC.

By: /s/ Regina Sommer

Regina Sommer
Chief Financial Officer

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EXHIBIT INDEX

Exhibit No.	Exhibit
2.1*	Agreement and Plan of Merger dated as of October 24, 2001 by and among Netegrity, Inc., LKN Acquisition Corp., and DataChannel, Inc., as amended by the First Amendment to the Agreement and Plan of Merger, dated as of December 3, 2001 and the Second Amendment to the Agreement and Plan of Merger, dated as of December 7, 2001.
23.1	Consent of Ernst & Young LLP
23.2	Consent of Arthur Andersen, LLP

* Previously filed.