VERTICALNET INC
Form 10-Q
November 14, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2006

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 000-25269

VERTICALNET, INC.

(Exact name of registrant as specified in its charter)

Pennsylvania	**23-2815834**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
400 CHESTER FIELD PARKWAY	**19355**

MALVERN, PENNSYLVANIA
(Address of principal executive offices) **(Zip Code)**
Registrant s telephone number, including area code: (610) 240-0600

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

Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No x

The number of shares outstanding of the registrant s common stock as of November 10, 2006 was 8,785,974 (includes 48,294 shares subject to an escrow agreement in connection with a prior acquisition).

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VERTICALNET, INC.

FORM 10-Q

For the Quarterly Period Ended September 30, 2006

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Part I. Financial Information

Item 1. Consolidated Financial Statements

VERTICALNET, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

	September 30, 2006 (unaudited)	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 2,467	$ 4,576
Restricted cash		155
Accounts receivable, net	4,857	5,188
Prepaid expenses and other current assets	1,080	735
Total current assets	8,404	10,654
Property and equipment, net	1,000	1,288
Goodwill	9,643	19,331
Other intangible assets, net	2,643	4,003
Other assets	592	768
Total assets	$ 22,282	$ 36,044
Liabilities and Shareholders Equity		
Current liabilities:		
Current portion of long-term debt, convertible notes, and other non-current liabilities	$ 7,754	$ 2,638
Accounts payable and accrued expenses	4,939	4,038
Deferred revenues	4,057	3,297
Total current liabilities	16,750	9,973
Non-current portion of deferred revenues	765	313
Derivative liabilities		1,321
Long-term debt, convertible notes, and other non-current liabilities	263	2,041
Total liabilities	17,778	13,648
Commitments and contingencies (see Notes 2, 6, 7, and 8)		
Shareholders equity:		
Preferred stock $.01 par value, 10,000,000 shares authorized, none issued at September 30, 2006 and December 31, 2005		
Common stock $.01 par value, 21,428,571 shares authorized at September 30, 2006 and 14,285,714 at December 31, 2005, 8,329,467 shares issued at September 30, 2006 and 7,081,345 shares issued at December 31, 2005	83	71
Additional paid-in capital	1,229,699	1,226,469
Deferred compensation		(593)
Accumulated other comprehensive loss	(127)	(403)
Accumulated deficit	(1,224,346)	(1,202,343)

		5,309		23,201
Treasury stock at cost, 9,377 shares at September 30, 2006 and December 31, 2005		(805)		(805)
Total shareholders equity		4,504		22,396
Total liabilities and shareholders equity	$	22,282	$	36,044

See accompanying notes to consolidated financial statements.

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VERTICALNET, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenues:				
Software and software related	$ 2,343	$ 1,609	$ 5,774	$ 4,721
Services	1,830	3,289	6,500	10,497
Total revenues	4,173	4,898	12,274	15,218
Cost of revenues:				
Cost of software and software related	529	627	1,702	2,085
Cost of services	1,047	1,872	4,131	5,653
Amortization of acquired technology and customer contracts	272	268	768	747
Total cost of revenues	1,848	2,767	6,601	8,485
Gross profit	2,325	2,131	5,673	6,733
Operating expenses:				
Research and development	1,201	1,831	4,074	5,297
Sales and marketing	1,630	2,155	5,464	6,181
General and administrative	1,547	1,527	4,885	4,505
Litigation and settlement costs	6	154	1,032	192
Restructuring charges (reversals)	(21)	149	195	473
Impairment charge for goodwill			9,877	
Amortization of other intangible assets	201	344	660	969
Total operating expenses	4,564	6,160	26,187	17,617
Operating loss	(2,239)	(4,029)	(20,514)	(10,884)
Interest and other expense (income), net	1,145	(369)	1,489	(71)
Net loss	$ (3,384)	$ (3,660)	$ (22,003)	$ (10,813)
Basic and diluted loss per common share	$ (0.42)	$ (0.57)	$ (2.89)	$ (1.76)
Basic and diluted weighted average common shares outstanding	8,061	6,457	7,616	6,161

See accompanying notes to consolidated financial statements.

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VERTICALNET, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(in thousands)

	Nine Months Ended September 30,	
	2006	**2005**
Operating activities:		
Net loss	$ (22,003)	$ (10,813)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,839	2,187
Stock-based compensation	1,414	628
Impairment of goodwill	9,877	
Accretion of promissory notes and non-cash interest	1,820	218
Change in the fair value of derivative liabilities	(1,265)	(663)
Amortization of deferred financing costs	467	48
Write-down related to cost method investment		364
Other non-cash items	9	
Change in assets and liabilities, net of effect of acquisition:		
Accounts receivable	331	1,660
Prepaid expenses and other assets	345	197
Accounts payable and accrued expenses	1,479	(1,401)
Deferred revenues	1,212	(141)
Net cash used in operating activities	(4,475)	(7,716)
Investing activities:		
Acquisitions related payments	(57)	(309)
Capital expenditures	(77)	(322)
Restricted cash	155	
Proceeds from sale of cost, equity method, and available-for-sale investments		242
Net cash provided by (used in) investing activities	21	(389)
Financing activities:		
Principal payments on long-term debt and obligations under capital leases	(1,364)	(656)
Proceeds from issuance of senior convertible notes, net		5,951
Proceeds from issuance of senior subordinated discount note, net	3,677	
Proceeds from exercise of stock options and issuance of non-vested stock	11	73
Net cash provided by financing activities	2,324	5,368
Effect of exchange rate fluctuation on cash and cash equivalents	21	(88)
Net decrease in cash and cash equivalents	(2,109)	(2,825)
Cash and cash equivalents - beginning of period	4,576	9,370
Cash and cash equivalents - end of period	$ 2,467	$ 6,545
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	$ 260	$ 29

Supplemental schedule of non-cash investing and financing activities:		
Conversion of and payments on senior convertible promissory notes and accrued interest into/with common stock	$ 2,394	$
Financed insurance policies	663	816
Capital expenditures financed through capital lease arrangements	42	141
Issuance of common stock as consideration for the Digital Union acquistion		2,973
Issuance of warrants to private placement agent		35

See accompanying notes to consolidated financial statements.

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VERTICALNET, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY (UNAUDITED)

(in thousands)

	Common Stock							
	Shares	**Amount**	**Additional Paid-in Capital**	**Deferred Compensation**	**Accumulated Other Comprehensive Loss**	**Accumulated Deficit**	**Treasury Stock**	**Total Shareholders Equity**
Balance, January 1, 2006 (Note 1)	7,081	$ 71	$ 1,226,469	$ (593)	$ (403)	$ (1,202,343)	$ (805)	$ 22,396
Reclassification of deferred compensation upon adoption of SFAS No. 123R			(593)	593				
Exercise of stock options, non-vested stock, and restricted units	37		2					2
Issuance of common stock to employees	1		6					6
Conversion of and payments on senior convertible promissory notes and accrued interest into / with common stock (Note 6)	1,067	11	2,383					2,394
Reclassification of warrants			10					10
Issuance of non-vested stock, net	143	1	8					9
Stock-based compensation expense			1,414					1,414
Net loss						(22,003)		(22,003)
Other comprehensive income					276			276
Balance, September 30, 2006	8,329	$ 83	$ 1,229,699	$	$ (127)	$ (1,224,346)	$ (805)	$ 4,504

See accompanying notes to consolidated financial statements.

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VERTICALNET, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS (UNAUDITED)

(in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net loss	$ (3,384)	$ (3,660)	$ (22,003)	$ (10,813)
Foreign currency translation adjustment	73	77	276	(56)
Comprehensive loss	$ (3,311)	$ (3,583)	$ (21,727)	$ (10,869)

See accompanying notes to consolidated financial statements.

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VERTICALNET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Summary of Significant Accounting Policies

Description of Company

Verticalnet, Inc., which was incorporated on July 28, 1995 under the laws of Pennsylvania, is referred to throughout the consolidated financial statements as Verticalnet, the Company, we, us, or through similar expressions.

We are a provider of On-Demand Supply Management solutions to companies ranging in size from mid-market to the Global 2000. We provide a full scope of Supply Management software, services, and domain expertise in areas that include: Program Management, Spend Analysis, eSourcing, Contract Management, and Supplier Performance Management.

Basis of Presentation

Our consolidated financial statements include the accounts of our wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. The accompanying financial statements have been prepared assuming that the company will continue as a going concern and accordingly the financial statements do not include any adjustments (see Note 2).

Reclassifications

The Company has made certain reclassifications to prior period amounts in the statement of operations to conform to the current period presentation, none of which affected net loss or net loss per share. Specifically, with the adoption of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment, the Company has reclassified $211,000 of stock-based compensation into cost of revenues and research and development, sales and marketing, and general and administrative expenses for the three months ended September 30, 2005. For the nine months ended September 30, 2005, we reclassified $628,000 of stock-based compensation into cost of revenues and research and development, sales and marketing, and general and administrative expenses. In addition, the Company has separately identified litigation and settlement costs of $154,000 and $192,000 for the three and nine months ended September 30, 2005, respectively. Litigation costs have been reclassified out of general and administrative costs and into a separate line item within operating expenses on the accompanying consolidated statements of operations. The following table reflects the effect of all of these reclassifications for the three and nine months ended September 30, 2005 (in thousands):

	Three Months Ended September 30, 2005		**Nine Months Ended September 30, 2005**	
	As previously reported	**As reclassified**	**As previously reported**	**As reclassified**
Cost of revenues - software and software related	$ 624	$ 627	$ 2,079	$ 2,085
Cost of revenues - services	1,834	1,872	5,575	5,653
Research and development	1,823	1,831	5,271	5,297
Sales and marketing	2,084	2,155	5,946	6,181
General and administrative	1,590	1,527	4,414	4,505
Stock-based compensation	211		628	
Litigation and settlement costs		154		192

Reverse Stock Split

At the Company s 2006 Annual Meeting of Shareholders held on May 19, 2006, the Company s shareholders approved an amendment to the Company s Amended and Restated Articles of Incorporation to effect a reverse stock split of the Company s outstanding common stock at an exchange ratio of not less than one-for-three and not more than one-for-seven, and authorized the Company s Board of Directors to implement a reverse stock split within this range at any time prior to the 2007 Annual Meeting of Shareholders.

On June 12, 2006, the Company effected a one-for-seven reverse split of its outstanding shares of common stock, par value $0.01 per share (the Reverse Split). Pursuant to the Reverse Split, each holder of seven shares of the Company s common stock became the holder of one share of the Company s common stock. All outstanding options, warrants, convertible notes or other rights convertible into or exercisable for shares of common stock, were adjusted in accordance with their terms and pursuant to the ratio of the Reverse Split. No fractional shares were issued in

connection with the Reverse Split. Any fractional shares resulting from the Reverse Split were rounded up to the nearest whole share and no cash payment was made in respect to such rounding.

All references in the consolidated financial statements to shares and per share amounts have been adjusted for this reverse split.

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On June 8, 2006, the Company filed an Amendment to its Amended and Restated Articles of Incorporation (the Amendment) with the Secretary of State of the Commonwealth of Pennsylvania to effect: (i) the Reverse Split; and (ii) an increase the number of authorized shares of common stock to 21,428,571 shares.

Use of Estimates

The preparation of financial statements in conformity with U.S. 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.

Restricted Cash

Restricted cash balances represent certificates of deposit held pursuant to a building lease agreement. At September 30, 2006 and December 31, 2005, we had approximately $156,000 of restricted cash classified as non-current other assets on the consolidated balance sheets. In addition, at December 31, 2005, we had approximately $155,000 of restricted cash classified within current assets that was released from restrictions in February 2006.

Intangible Assets and Other Long-Lived Assets

In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead are tested for impairment annually or more frequently if certain indicators arise. In addition, SFAS No. 142 also requires that intangible assets with estimable useful lives be amortized over their respective useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets.

We perform the annual goodwill impairment test in the fourth quarter of each fiscal year. In June 2006, based on our then current market capitalization as well as other business indicators (including the Company s decreasing relationship with one of the Company s largest customers), we concluded we were required to assess whether any portion of our recorded goodwill balance was impaired. This test requires a comparison of the fair value of a reporting unit with its carrying amount, including goodwill. The Company consists of one reporting unit. For purposes of the impairment test, we consider the market capitalization of the Company, to be representative of its fair value. Accordingly, we estimated the fair value of the Company based on the total number of shares outstanding multiplied by the closing stock price on June 30, 2006, and compared such amount to the carrying value of the Company s net assets at that time. Based on our analysis, the Company s fair value was less than the carrying value of the Company s net assets, thereby necessitating that we assess our recorded goodwill for impairment. As required by SFAS No. 142, in measuring the amount of goodwill impairment, we made a hypothetical allocation of the estimated fair value of the Company to the tangible and intangible assets (other than goodwill) and liabilities. Based on this allocation, we concluded that goodwill was impaired in the amount of $9.9 million.

As of September 30, 2006, the fair value of the Company was greater than the carrying value of the Company s net assets. Accordingly, no impairment was indicated. As of September 30, 2006, and through the date of the filing of this Form 10-Q, the Company s market value has continued to decline. If our market value continues to decline, we may get to a point where an additional impairment charge would be necessary. At that time we may be required to record a significant charge to earnings in our financial statements during the period in which the amount of the impairment of our goodwill or amortizable intangible assets is determined.

In accordance with SFAS No. 144, long-lived assets, other than goodwill, are reviewed for impairment whenever, in management s judgment, conditions indicate a possible loss. Such impairment tests compare estimated undiscounted cash flows to the carrying value of the asset. If an impairment is indicated, the asset is written down to its fair market value based on an estimate of its discounted cash flows.

Financial Instruments

In accordance with the requirements of SFAS No. 107, Disclosures about Fair Value of Financial Instruments, we have determined the estimated fair value of our financial instruments using available market information and valuation methodologies. As of September 30, 2006 and December 31, 2005, our financial instruments included cash equivalents, cost method investments, accounts receivable, accounts payable, capital leases, derivative and other liabilities, and convertible notes. Considerable judgment is required to develop the estimates of fair value; thus, the estimates are not necessarily indicative of the amounts that could be realized in a current market exchange. However, we believe the carrying values of these assets and liabilities, with the exception of the capital leases, derivative and other liabilities, promissory notes, and the

cost method investments, are a reasonable estimate of their fair market values at September 30, 2006 and December 31, 2005 due to the short maturities of such items. The Company believes that

the fair values of the cost method investments, capital leases, promissory notes, and other liabilities are not materially different from the carrying values. The derivative liabilities are recorded at fair value on the consolidated balance sheet as of September 30, 2006 and December 31, 2005.

Concentration of Credit Risk

Financial instruments that potentially subject us to concentrations of credit risk consist primarily of cash and cash equivalents in bank deposit accounts and trade receivables. Cash and cash equivalents are held with high quality financial institutions. We periodically perform credit evaluations of our customers and maintain reserves for potential losses, if necessary. We do not anticipate losses from these receivables in excess of the provided allowances. See Revenue Recognition below for additional information on credit and revenue concentrations.

Revenue Recognition

Software and software related revenues

Software and software related revenues have been principally derived from the licensing of our products, from maintenance and support contracts, from third-party software reseller commissions, and from hosting services. Customers who license our products also generally purchase maintenance contracts which provide software updates and technical support over a stated term, which is usually a twelve-month period. As part of licensing our products, a customer may also purchase custom development and implementation services from us.

Our products are either acquired under a perpetual license model or under a time-based license model. The license agreements for our products do not provide for a right of return other than during the warranty period, and historically product returns have not been significant. We do not recognize revenue for agreements with cancellation rights or refundable fees until such rights to refund or cancel have expired.

We recognize revenue related to software arrangements in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions. We recognize revenue when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery of the product has occurred; the fee is fixed or determinable; and collectibility is probable. We consider all arrangements with payment terms outside of our normal payment terms to not be fixed or determinable, and revenue under these agreements is recognized as payments become due from the customer. If collectibility is not considered probable, revenue is recognized when the fee is collected.

The Company recognizes revenue from the commissions on third-party reseller arrangements upon delivery of the related license to the end user customer by the software vendor, as well as compliance with the other revenue recognition criteria. During the three and nine months ended September 30, 2006, the Company recorded $68,000 and $302,000, respectively, in third party software reseller commissions, primarily as a result of our relationship with IBM in the United Kingdom.

During the three months ended September 30, 2006, the Company recognized $800,000 in software and software related revenue pertaining to a perpetual licensing agreement. The agreement grants the customer access to, and use of, the source code of our Metaprise Private Exchange Platform.

SOP 97-2, as amended, generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of the elements. Our determination of fair value of each element in multi-element arrangements is based on vendor-specific objective evidence (VSOE). We limit our assessment of VSOE of fair value for each element to either the price charged when the same element is sold separately or the price established by management, having the relevant authority to do so, for an element not yet sold separately.

If evidence of fair value for all undelivered elements exists but evidence does not exist for one or more delivered elements, then revenue is recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. Revenue allocated to maintenance and support is recognized ratably over the maintenance term and revenue allocated to training and other service elements is recognized as the services are performed. The proportion of revenue recognized upon delivery of the software may vary from quarter to quarter depending upon the relative mix of licensing arrangements, the extent of services that will be required to implement the software, and whether VSOE of fair value exists for all of the undelivered elements.

Software arrangements that include professional services are evaluated to determine whether those services are essential to the

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functionality of the software elements of the arrangement. When services are not considered essential, the revenue allocable to the professional services is recognized as the services are performed. If we provide professional services that are considered essential to the functionality of the software products, both the software product revenue and professional service revenue are recognized in accordance with the provisions of SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. To date, most of our professional services provided in connection with software arrangements have been considered essential to the functionality of the software and therefore, the majority of our contracts that involved licenses and professional services have been recognized on a percentage of completion basis.

Hosted term-based licenses, where the customer does not have the contractual right to take possession of the software, are accounted for in accordance with Emerging Issues Task Force (EITF) Issue No. 00-3, Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity s Hardware. Revenues related to such arrangements are recognized on a monthly basis over the term of the contract. Amounts that have been invoiced are recorded in accounts receivable and in deferred revenue or revenue, depending on whether the revenue recognition criteria have been met.

Arrangements that include professional services sold with hosted term-based licenses and support offerings are evaluated under EITF Issue No. 00-21, Revenue Arrangements with Multiple Deliverables, and the Securities and Exchange Commission s Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition. To the extent the professional services have value to the customer on a stand-alone basis and there is objective and reliable evidence of fair value of the undelivered elements, the consideration from the arrangement is allocated among the separate elements based upon their relative fair values and professional services revenues are recognized as the services are rendered. Hosted term-based licenses, as well as any professional services that do not meet the above criteria, which have historically been the majority of the Company s services, are recognized ratably over the term of the agreement.

Services revenues

Consulting contracts with fixed-priced arrangements are recognized using the percentage-of-completion method. Percentage-of-completion accounting involves calculating the percentage of services provided during the period compared to the total estimated services to be provided over the duration of the contract. This method is followed where reasonably dependable estimates of the revenues and costs applicable to various elements of a contract can be made. Estimates of total contract revenues and costs are continuously monitored during the term of the contract, and recorded revenues and costs are subject to revision as the contract progresses. Such revisions may result in increases or decreases to revenues and results of operations and are reflected in the consolidated financial statements in the period in which they are first identified. Consulting services with fees based on time and materials or cost-plus are recognized in accordance with SAB No. 104 as the services are performed (as measured by time incurred) and amounts earned.

We consider amounts under consulting contracts to be earned once evidence of an arrangement has been obtained, services are delivered, fees are fixed or determinable, and collectibility is reasonably assured. In such contracts, our efforts, generally measured by time incurred, typically is reflective of progress against the contractual milestones or output measure, which is the contractual earnings pattern. Contingent or incentive revenues relating to consulting contracts are recognized when the contingency is satisfied and we conclude the amounts are earned.

As of and for the nine months ended September 30, 2006 and 2005, revenues and amounts due from our largest customers were as follows (in thousands):

	2006			2005		
Customer	**Accounts Receivable Balance (a)**	**Revenues**	**% of Total Revenues**	**Accounts Receivable Balance (a)**	**Revenues**	**% of Total Revenues**
A	$ 154	$ 1,460	11.9 %	$ 1,223	$ 4,140	27.2 %
B	85	2,049	16.7	648	2,546	16.7
All others, net of allowance	4,618	8,765	71.4	2,864	8,532	56.1
Total	$ 4,857	12,274	100.0 %	$ 4,735	15,218	100.0 %

(a) Represents both billed and unbilled amounts.

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Revenues from the same customers for the three months ended September 30, 2006 and 2005 were as follows (in thousands):

	2006		2005	
Customer	**Revenues**	**% of Total Revenues**	**Revenues**	**% of Total Revenues**
A	$ 240	5.8 %	$ 1,436	29.3 %
B	1,013	24.3	741	15.1
All others, net of allowance	2,920	70.0	2,721	55.6
Total	$ 4,173	100.0 %	$ 4,898	100.0 %

Stock Options

The Company maintains stock-based compensation plans which allow for the issuance of stock options, restricted stock units (RSU s), and non-vested common stock to executives, directors, and employees. Prior to January 1, 2006, the Company accounted for the plans under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Accordingly, the intrinsic value of the non-vested stock, restricted stock units, and stock option grants, with an exercise price less then the market value of the underlying common stock on the date of the grant, were recognized in the consolidated statement of operations under APB Opinion No. 25.

Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123R. SFAS No. 123R sets accounting requirements for share-based compensation to employees and non-employee directors, including employee stock purchase plans, and requires companies to recognize in the statement of operations the grant-date fair value of stock options and other equity-based compensation. Additionally, under the modified prospective method of adoption, the Company recognizes compensation expense for the portion of outstanding awards on the adoption date for which the requisite service period has not yet been rendered based on the grant-date fair value of those awards calculated under SFAS No. 123, Accounting for Stock-Based Compensation, and SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, for pro forma disclosures. Compensation expense determined under a fair-value-based method in fiscal year 2005 continues to be disclosed on a pro forma basis only. As a result of the Company s adoption of SFAS No. 123R, we recorded $142,000 and $527,000 of additional stock based compensation, related to stock options, for the three and nine months ended September 30, 2006, respectively.

Pro forma net loss and loss per share, as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation for periods presented prior to the Company s adoption of SFAS No. 123R, are as follows (in thousands, except per share data):

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net loss:		
Net loss, as reported	$ (3,660)	$ (10,813)
Add: Stock-based employee compensation included in reported net loss	211	628
Deduct: Stock-based employee compensation expense determined under fair-value-based method for all awards	(632)	(2,204)
Pro forma net loss	$ (4,081)	$ (12,389)
Loss per common share basic and diluted:		
As reported	$ (0.57)	$ (1.76)
Pro forma	$ (0.63)	$ (2.01)

Foreign Currency Translation

We translate the assets and liabilities of international subsidiaries into U.S. dollars at the current rates of exchange in effect as of each balance sheet date. Revenues and expenses are translated using average rates in effect during the period. Foreign currency translation adjustments are included in accumulated other comprehensive loss on the consolidated balance sheet. Foreign currency transaction gains or losses are recognized

in current operations and have not been significant to our operating results in any period. In addition, the effect of foreign currency rate changes on cash and cash equivalents has not been significant in any period.

Contingencies

The Company records accruals for contingencies arising from claims, assessments, litigation, fines, and penalties and other sources when it is probable that a liability has been incurred and the amount can be reasonably estimated. Legal costs expected to be incurred in connection with a loss contingency are accrued when probable and reasonably estimable.

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Accounting for Derivatives

We account for derivatives in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended, which provides accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. Derivative instruments embedded in contracts, such as conversion and prepayment features are considered derivative instruments and are required by SFAS No. 133, to the extent not already a free standing contract, to be bifurcated from the debt instrument and accounted for separately. All derivatives, whether designated in hedging relationships or not, are recorded on the consolidated balance sheet at fair value. See Note 6 for additional information regarding the Company s outstanding derivatives.

Comprehensive Loss

We report comprehensive loss in accordance with the provisions of SFAS No. 130, Reporting Comprehensive Income, which establishes standards for reporting comprehensive loss and its components in financial statements. Comprehensive loss, as defined, includes all changes in equity during a period from non-owner sources.

Computation of Historical Loss Per Common Share

Basic loss per common share is computed using the weighted average number of common shares outstanding during the period, exclusive of non-vested stock grants. Diluted loss per common share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the period, including incremental common shares issuable upon the exercise of stock options and warrants (using the treasury stock method), the conversion of our senior secured convertible promissory notes, and non-vested stock grants. Common equivalent shares are excluded from the calculation if their effect is anti-dilutive.

During the three and nine months ended September 30, 2006 and 2005, the diluted loss per common share calculation was the same as the basic loss per common share calculation as all potentially dilutive securities were anti-dilutive.

As a result, potentially dilutive common shares of 3,137,299 and 3,973,327 as of September 30, 2006 and 2005, respectively, were excluded from the computation of diluted loss per common share because their effect was anti-dilutive.

As a result of the Digital Union Limited acquisition (see note 3), there were 95,544 shares of common stock that were held in escrow. Of those held in escrow, 47,250 shares were released in July 2006 and the remaining 48,294 will be released in the first quarter of 2007. The shares released in July 2006 have only been included in the loss per share calculation subsequent to their release date of July 22, 2006. The remaining shares were excluded from the loss per share calculations during the three and nine months ended September 30, 2006 and 2005, and will be included subsequent to their release dates. In addition, 7,075 shares held in escrow in connection with the acquisition of B2eMarkets, Inc. were only included in the loss per share calculation subsequent to their release date of February 25, 2005.

All loss per share calculations have been adjusted for the Reverse Split (see Reverse Stock Split above).

Recent Accounting Pronouncements

In February 2006, the Financial Accounting Standards Board issued (FASB) SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, which amends SFAS No. 133, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS No. 155 provides guidance to simplify the accounting for certain hybrid instruments by permitting fair value remeasurement for any hybrid financial instrument that contains an embedded derivative, as well as, clarifies that beneficial interests in securitized financial assets are subject to SFAS No. 133. In addition, SFAS No. 155 eliminates a restriction on the passive derivative instruments that a qualifying special-purpose entity may hold under SFAS No. 140. SFAS No. 155 is effective for all financial instruments acquired, issued, or subject to a new basis occurring after the beginning of an entity s first fiscal year that begins after September 15, 2006. An entity may apply SFAS No. 155 on an instrument-by-instrument basis to instruments that it holds at the date of adoption. We believe that the adoption of this statement will not have a material effect on our financial condition or results of operations.

In June 2006, the FASB issued FASB Interpretation 48, Accounting for Uncertainty in Tax Positions, (FIN 48) to clarify the criteria for recognizing tax benefits under FASB Statement No. 109, Accounting for Income Taxes, and to require additional financial statement disclosure. FIN 48 requires that we recognize, in our consolidated financial statements, the impact of a tax position if that position is more-likely-than-not to be sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective for us beginning January 1, 2007, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening accumulated deficit. At this time, we have not completed the evaluation of the impact that the adoption of FIN 48 could have on our financial position, results of operations, and cash

flows.

In June 2006, EITF issued EITF Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation), to clarify diversity in practice on the presentation of different types of taxes in the financial statements. The Task Force concluded that, for taxes within the scope of the issue, a company may adopt a policy of presenting taxes either gross within revenue or net. That is, it may include charges to customers for taxes within revenues and the charge for the taxes from the taxing authority within cost of sales, or, alternatively, it may net the charge to the customer and the charge from the taxing authority. If taxes subject to EITF No. 06-3 are significant, a company is required to disclose its accounting policy for presenting taxes and the amounts of such taxes that are recognized on a gross basis. The guidance in this consensus is effective for the first interim reporting period beginning after December 15, 2006. The Company will adopt EITF No. 06-3 as of January 1, 2007. The adoption of EITF No. 06-3 is not expected to have a significant impact on our consolidated financial statements.

In September 2006, the FASB issued FASB No. 157, Fair Value Measurements. SFAS No. 157 is definitional and disclosure oriented and addresses how companies should approach measuring fair value when required by U.S. Generally Accepted Accounting Principles (GAAP); it does not create or modify any current GAAP requirements to apply fair value accounting. The standard provides a single definition for fair value that is to be applied consistently and also generally describes and prioritizes according to reliability the methods and inputs used in valuations. SFAS No. 157 prescribes various disclosures about financial statement categories and amounts which are measured at fair value, if such disclosures are not already specified elsewhere in GAAP. The new measurement and disclosure requirements of SFAS No. 157 are effective for the Company in the first quarter 2008. The Company expects no significant impact from adopting the standard.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB No. 108), Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB No. 108 addresses diversity in practice in quantifying financial statement misstatements. SAB No. 108 requires the quantification of misstatements based on their impact to both the balance sheet and the income statement to determine materiality. The guidance provides for a one-time cumulative effect adjustment to correct for misstatements for errors that were not deemed material under a company s prior approach but are material under the SAB No. 108 approach. SAB No. 108 is effective for the fiscal year ending December 31, 2006. The Company is in the process of determining the effect, if any, the adoption of SAB No. 108 will have on its financial statements.

(2) Liquidity

We currently believe that we will be able to finance our capital requirements and anticipated operating losses through September 30, 2007, assuming that we (i) are able to obtain the Consent (defined below) from the holders of our $6.6 million senior secured promissory notes (the Senior Notes), which we are currently seeking and which will extend the due date of our $5.3 million senior subordinated discounted promissory note (the Discount Note) from January 2007 to November 2007, (ii) the Senior Notes and Discount Note are not called within this timeframe, (iii) are able to repay a portion of the Senior Notes with our common stock as discussed below, (iv) are able to sell or license certain non-strategic technology assets, and (v) our actual revenues and expenses are within our current projected estimates.

Given our current cash level and debt repayment schedules, we believe we may seek to obtain additional debt or equity financing or seek to restructure or refinance our existing indebtedness, subject to obtaining any required consent from the holders of the Senior Notes and the Discount Note, which may result in the issuance of additional debt or equity securities that may further dilute our existing shareholders. In addition, we are exploring the licensing of certain non-strategic technology assets to enhance our liquidity and further reduce our cost structure, as well as the sale of specific non-strategic technology assets redundant with our core technology products subject to obtaining the consent of the holders of our Senior Notes and Discount Note to dispose of such assets. In the event that we are successful in the sale or licensing of these non-strategic assets we may be required to use the proceeds to reduce the balance of the outstanding Senior Notes or Discount Note. During the three months ended September 30, 2006, the Company collected $800,000 related to restructuring a perpetual license agreement for our Metaprise Private Exchange Platform.

As of September 30, 2006, we had cash and cash equivalents of $2.5 million and the outstanding payments to be made under our Senior Notes and Discount Note are $3.1 million and $5.3 million, respectively, plus interest.

Under the terms of the Senior Notes, we are required to maintain a cash balance of at least $1.5 million. As of September 30, 2006, the amount of each remaining monthly principal payment under the Senior Notes is as follows: $317,500 from October 2006 through February 2007; $305,450 in March 2007; and $292,500 from April 2007 through July 2007. Under the terms of our Discount Note, we are prohibited from paying the monthly principal and interest payments under the Senior Notes in cash to the extent we can make such payments in shares of our common stock in accordance with the terms of the Senior Notes. In the past, we have typically made the monthly principal and interest payments under the Senior Notes in shares of our common stock, or a combination of cash and shares of our common stock. Under the terms of the Senior Notes, the number of shares we can use to pay principal and interest under the Senior Notes is subject to limitations based on the trading volume of our common stock. Recently, the price and the trading volume of our common stock has declined, and as a result, we have not been able to make the entire principal and interest payments under the Senior Notes in shares of common stock. If we cannot make principal and interest

payments under the Senior Notes with shares of common stock, we will have to use our available cash to make such payments and, as a result, may need to accelerate our alternatives set forth above (see Note 6).

As of September 30, 2006, an aggregate amount of $5.3 million plus accrued interest may be declared due by the holder of the Discount Note at any time after January 31, 2007 (see below for additional information). As a result, the obligations under the Discount Note (net of discount) have been reflected on our consolidated balance sheet as of September 30, 2006 in current portion of long-term debt because the obligations under the Discount Note could be declared due within one year.

Pursuant to the Discount Note, if we are unable to obtain the consent of the holders of our Senior Notes to permit us to grant the holder of the Discount Note a subordinated lien and security interest in all of our assets and the assets of our subsidiaries (the Consent), the holder of the Discount Note can declare the Discount Note due at any time after January 31, 2007. If we obtain the Consent from the holders of the Senior Notes before January 31, 2007, the maturity date of the Discount Note will be November 18, 2007. We are currently seeking the Consent of the holders of our Senior Notes. To induce the holders of the Senior Notes to grant us the Consent, we may need to provide them with additional incentives, including issuing additional equity securities or modifying the terms of their Senior Notes and warrants, which may result in further dilution of our existing shareholders. No assurance can be made that we will be able to obtain the Consent and as a result we may need to accelerate our plans noted above.

On September 27, 2006, we received written notification (the Notice) from the Nasdaq Capital Market (Nasdaq) that for 30 consecutive trading days the bid price of our common stock had closed below the minimum $1.00 per share (the Minimum Price Requirement) required for continued listing under Nasdaq Marketplace Rule 4310(c)(4) (the Rule). We have been provided an initial period of 180 calendar days, or until March 26, 2007, to regain compliance. The Notice states the Nasdaq staff (the Staff) will provide written notification that the Company has achieved compliance with the Rule if at any time before March 26, 2007, the bid price of our common stock closes at $1.00 per share or more for a minimum of 10 consecutive business days, although the Notice also states that the Staff has the discretion to require compliance for a period in excess of 10 consecutive business days, but generally no more than 20 consecutive business days, under certain circumstances.

If we cannot demonstrate compliance with the Rule by March 26, 2007, the Staff will determine whether we meet the Nasdaq Capital Market initial listing criteria set forth in Marketplace Rule 4310(c), except for the bid price requirement. If we meet the initial listing criteria, the Staff will notify us that it has been granted an additional 180 calendar day compliance period. If we are not eligible for an additional compliance period, the Staff will provide written notice that our securities will be delisted. At that time, we may appeal the Staff s determination to de-list our securities to a Listing Qualifications Panel. As of November 1, 2006, we do not meet the initial listing criteria of having shareholders equity of at least $5 million.

There can be no assurance that our common stock will trade above $1.00 per share or that we will meet all of the listing criteria for The Nasdaq Capital Market in the future.

As of September 30, 2006, we were in compliance with the covenants under the Senior Notes and the Discount Note. However, no assurance is made that we will remain in compliance with all of the covenants under the Senior Notes and the Discount Note, including the covenants relating to listing our shares on the OTC Bulletin Board or another acceptable exchange if we are delisted from The Nasdaq Capital Market or not receiving a qualification from our auditors as to our ability to continue as a going concern. The Senior Notes and the Discount Note contain cross-default provisions, which means that a default under either instrument results in a default under the other instrument. If we are unable to comply with the covenants under the Senior Notes or the Discount Note, the holders of the Senior Notes and the Discount Note may declare us in default and may declare all amounts due under the notes.

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(3) Acquisition

On July 22, 2005, Verticalnet entered into a Share Purchase Agreement (the Share Purchase Agreement) with Patrick Lawton, Brent Summers, Peter Linsell, Andrew Knotts, Colin Robertson, and Alphen Trading Limited (collectively, the DU Shareholders). Pursuant to the Share Purchase Agreement, Verticalnet acquired all of the outstanding capital stock of Digital Union Limited (Digital Union), a private limited company registered in England, from the DU Shareholders. In exchange for the outstanding capital stock of Digital Union, Verticalnet issued the DU Shareholders an aggregate of 636,956 shares of Verticalnet common stock. Under the Share Purchase Agreement, DU Shareholders were able to receive up to an additional 500,000 shares of Verticalnet common stock in the aggregate if certain revenue based milestones were achieved within the first year after the closing of the transaction. These milestones were not achieved and therefore no additional shares were issued. Digital Union was a privately-held provider of on-demand sourcing and procurement solutions based in Guildford, Surrey, United Kingdom. Digital Union became a wholly-owned subsidiary of Verticalnet subsequent to the acquisition. Digital Union s results have been included in the Company s results since July 23, 2005.

The consideration for the purchase transaction was approximately $3.5 million, including transaction costs of approximately $500,000, which primarily consisted of fees paid for professional services. Pursuant to the Share Purchase Agreement, Verticalnet issued an aggregate amount of 636,956 shares of common stock, valued on the date of closing at approximately $3.0 million. A total of 95,544 of the shares were being held in escrow, of which 47,250 shares were released in July 2006 and 48,294 will be released in the first quarter of 2007.

In accordance with SFAS No. 141, Business Combinations, the Company allocated the purchase price to the tangible and intangible assets acquired and the liabilities assumed, based on their estimated fair values. The excess of the purchase price over the fair values was recorded as goodwill. The fair value assigned to intangible assets acquired was based on a valuation performed by an independent third-party valuation firm. The total purchase price was allocated as follows (in thousands):

Current assets	$ 830
Property and equipment	71
Goodwill	3,049
Intangible assets	782
Total assets acquired	4,732
Current liabilities	(1,253)
Total purchase price	$ 3,479

Unaudited Pro Forma Information

The unaudited financial information in the table below summarizes the combined results of operations of Verticalnet and Digital Union, on a pro forma basis, as though the companies had been combined as of the beginning of the period presented. This pro forma financial information is presented for informational purposes only and is not necessarily indicative of the results of operations that

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would have been achieved had the acquisitions taken place at the beginning of the period presented. The unaudited pro forma information for the nine months ended September 30, 2005 combines the historical results for Verticalnet for the nine months ended September 30, 2005 and the historical results of Digital Union for the six months ended June 30, 2005. The following pro forma information is in thousands, except per share amounts.

	Nine months ended September 30, 2005
Revenue	$ 15,955
Net loss	$ (12,570)
Basic and diluted loss per share	$ (1.92)
Basic and diluted weighted average shares outstanding	6,561

(4) Detail of Certain Balance Sheet Accounts

Accounts receivable, net consists of the following (in thousands):

	September 30, 2006	December 31, 2005
Accounts Receivable, trade	$ 4,117	$ 4,883
Unbilled accounts receivable	817	228
Retainage	8	81
	4,942	5,192
Less: allowance for doubtful accounts	(85)	(4)
	$ 4,857	$ 5,188

Unbilled accounts receivable represent revenue recognized for performance under customer contracts and agreements which have not been billed as of the period end. Retainage represents amounts withheld under contractual provisions by customers until the specific projects are completed. All amounts are expected to be billed and collected within one year.

Property and equipment, net consists of the following (in thousands):

	September 30, 2006	December 31, 2005
Software	$ 1,712	$ 1,694
Computer equipment	1,944	1,846
Office equipment and furniture	263	250
Leasehold improvements	890	888
	4,809	4,678
Less: accumulated depreciation and amortization	(3,809)	(3,390)
	$ 1,000	$ 1,288

From time to time, we enter into capital lease arrangements for property and equipment. As of September 30, 2006 and December 31, 2005, the gross amount included in computer equipment related to capital leases was $353,000 and $311,000, respectively. Accumulated amortization applicable to capital leases was $227,000 and $151,000 as of September 30, 2006 and December 31, 2005, respectively.

Depreciation and amortization related to property and equipment was $134,000 and $174,000 for the three months ended September 30, 2006 and 2005, respectively. Amortization applicable to property and equipment under capital leases of $23,000 and $24,000 for the three months ended September 30, 2006 and 2005, is included in such expense.

Depreciation and amortization related to property and equipment was $411,000 and $472,000 for the nine months ended September 30, 2006 and 2005, respectively. Amortization applicable to property and equipment under capital leases of $76,000 and $63,000 for the nine months ended September 30, 2006 and 2005, respectively, is included in such expense.

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Accounts payable and accrued expenses consist of the following (in thousands):

	September 30, 2006	December 31, 2005
Accounts payable	$ 2,863	$ 1,908
Legal and settlement liabilities (Note 8)	108	144
Taxes payable	615	612
Compensation and related costs	490	642
Restructuring costs (Note 10)	8	65
Acquisition related costs		57
Derivative liabilities	46	
Other	809	610
	$ 4,939	$ 4,038

(5) Goodwill and Other Intangibles

Other Intangibles

The following table reflects the components of amortizable intangible assets as of September 30, 2006 and December 31, 2005 (in thousands):

	Gross Carrying Amount	Accumulated Amortization	Net Book Value
September 30, 2006:			
Acquired technology	$ 3,726	$ 3,265	$ 461
Customer contracts and relationships	6,910	4,828	2,082
Non-compete agreements	251	153	98
Trademarks	11	9	2
	$ 10,898	$ 8,255	$ 2,643
December 31, 2005:			
Acquired technology	$ 3,713	$ 2,781	$ 932
Customer contracts and relationships	6,832	3,898	2,934
Non-compete agreements	250	119	131
Trademarks	10	4	6
	$ 10,805	$ 6,802	$ 4,003

In accordance with SFAS No. 144, long-lived assets, other than goodwill, are reviewed for impairment whenever, in management s judgment, conditions indicate a possible loss. Such impairment tests compare estimated undiscounted cash flows to the carrying value of the asset. If an impairment is indicated, the asset is written down to its fair market value based on an estimate of its discounted cash flows.

During the three months ended September 30, 2006 and 2005, we recognized $473,000 and $612,000, respectively, in intangible asset amortization expense.

During the nine months ended September 30, 2006 and 2005, we recognized $1.4 million and $1.7 million, respectively, in intangible asset amortization expense.

Goodwill

As of December 31, 2005, our goodwill balance consisted of $3.0 million from the Digital Union acquisition, $4.9 million from the Tigris Corp. acquisition, which occurred in January 2004, and $11.4 million from the B2eMarkets, Inc. acquisition, which occurred in July 2004.

In accordance with SFAS No. 142, we perform a test for impairment on an annual basis or as events and circumstances indicate that goodwill or other intangible assets may be impaired and that the carrying values may not be recoverable. We perform our annual assessment for impairment in the fourth quarter of each fiscal year. In June 2006, based on our then current market capitalization as well as other business indicators (including the Company s decreasing relationship with one of the Company s largest customers), we concluded that we were required to assess whether any portion of our recorded goodwill balance was impaired. This test requires a

comparison of the fair value of a reporting unit with its carrying amount, including goodwill. The Company consists of one reporting unit. For purposes of the impairment test, we consider the market capitalization of the Company to be representative of its fair value. Accordingly, we estimated the fair value of the Company based on the total number of shares outstanding multiplied by the closing stock price on June 30, 2006 ($1.29), and compared such amount to the carrying value of the Company s net assets at that time. Based on our analysis, the Company s fair value was less than the carrying value of the Company s net assets, thereby necessitating that we assess our recorded goodwill for impairment. As required by SFAS No. 142, in measuring the amount of goodwill impairment, we made a hypothetical allocation of the estimated fair value of the Company to the tangible and intangible assets (other than goodwill) and liabilities. Based on this allocation, we concluded that goodwill was impaired in the amount of $9.9 million, which is included in impairment charge for goodwill in the accompanying statement of operations for the nine months ended September 30, 2006.

As of September 30, 2006, the fair value of the Company was greater than the carrying value of the Company s net assets. Accordingly, no impairment was indicated. As of September 30, 2006, and through the date of the filing of this Form 10-Q, the Company s market value has continued to decline. If our market value continues to decline, we may get to a point where an additional impairment charge would be necessary. At that time we may be required to record a significant charge to earnings in our financial statements during the period in which the amount of the impairment of our goodwill or amortizable intangible assets is determined.

(6) Long-term Debt, Convertible Notes, Derivative Liabilities and Other Non-Current Liabilities

Long-term debt, convertible notes, and other non-current liabilities consist of the following (in thousands):

	September 30, 2006	December 31, 2005
Capital leases	$ 125	$ 161
Senior secured convertible promissory notes	2,611	4,419
Senior subordinated discount notes	4,674	
Other long-term liabilities	607	99
	8,017	4,679
Less: current portion of long-term debt, convertible notes, and other non-current liabilities	(7,754)	(2,638)
Long-term debt, convertible notes, and other non-current liabilities	$ 263	$ 2,041

Senior Secured Convertible Promissory Notes

On August 16, 2005, the Company issued senior secured convertible promissory notes in the aggregate principal amount of $6.6 million (the Senior Notes) to various independent institutional investors (the August Investors). The Senior Notes are secured by a security interest in all the assets of the Company, subject to existing liens, and are convertible into shares of Verticalnet s common stock, at the option of the August Investors, at a fixed conversion price of $4.90 per share (the Conversion Price), subject to adjustment upon certain conditions, including certain issuances of stock at a price below $4.90 per share, stock dividends or splits, and distributions of equity, debt, or assets. As of September 30, 2006, 629,780 shares would be issuable if the August Investors elected to convert the remaining principal amount of the Senior Notes and accrued interest. The Company also issued to the August Investors warrants to purchase an aggregate of 674,143 shares of Verticalnet common stock at an exercise price of $5.39 per share, subject to adjustment upon certain similar conditions, including certain issuances of stock at a price below $5.39 per share. The warrants are exercisable after six months from the closing date of the Senior Notes for a period of five years from the closing date. The term of the warrants can be extended by the August Investors for the number of days that the shares underlying the warrants are not saleable as a result of the suspension of trading of the Company s common stock on an applicable trading market and if the August Investors are not permitted to use the prospectus included in the registration statement for the resale of the shares. The Company also issued the placement agent for the transaction a warrant to purchase 20,205 shares of common stock having the same terms and conditions as the warrants issued to the August Investors.

The Senior Notes mature on July 2, 2007 (the Maturity Date) and accrue interest at 9% per annum from the issue date. Interest is payable monthly, in arrears, beginning December 2005 until the earlier of the Maturity Date or the date of conversion (the Conversion Date). Monthly principal payments of $330,000 commenced in December 2005 and are payable thereafter on the first business day of each month through July 2007 or the Conversion Date, whichever is sooner. As a result of several conversions during 2005 and 2006, the monthly principal payment has been reduced to approximately $318,000. At the Company s discretion, the Company may pay the monthly principal and interest payments in

cash, common stock, or a combination of cash and common stock, subject to certain limitations set forth in the Senior Notes, including the maximum amount of shares issued in a month cannot exceed 20% of the total dollar volume of the shares trading activity, as defined. The conversion price used for payments of principal and interest in shares of common stock will be equal to the Conversion Price if the average price of the Company s stock is at least 115%

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of the Conversion Price. If the average price of the Company s stock is not at least 115% of the Conversion Price, the conversion price used for payments of principal and interest in shares of common stock will be equal to 85% of the five lowest daily volume weighted average prices of the Company s common stock for the ten trading days before the date the Company elects to pay in shares of common stock. Upon the occurrence of certain events as set forth in the Senior Notes, the August Investors may require the Company to prepay the Senior Notes at 110% of the remaining principal amount of the Senior Notes or redeem the Senior Notes and under certain events, the related warrants at the then fair value determined by the related agreement.

On September 15, 2005, we filed the 2005 Registration Statement with the SEC that registered for resale the maximum number of shares of common stock we could issue, prior to obtaining the approval of our shareholders, for the payment of principal and interest on the Senior Notes or upon conversion of the Senior Notes. The 2005 Registration Statement also registered for resale the shares of common stock issuable upon exercise of the warrants. The 2005 Registration Statement was declared effective by the SEC on October 7, 2005. At our 2006 Annual Meeting of Shareholders held on May 19, 2006, our shareholders approved a proposal allowing us to issue an unlimited number of shares of common stock pursuant to the Senior Notes. As a result, on July 14, 2006, we filed another registration statement (the New Registration Statement) registering for resale our estimate of the number of shares of common stock issuable as payment for the remaining principal and interest payments on the Senior Notes or upon conversion of the Senior Notes. On September 20, 2006, the New Registration Statement was declared effective by the SEC.

The Company can cause a mandatory conversion of the Senior Notes into shares of common stock if after six months following the effective date of the 2005 Registration Statement the price of the Company s common stock exceeds 200% of the Conversion Price for a period of 20 consecutive days and certain other requirements are met. The agreements relating to the Senior Notes contain several non-financial covenants and the Company agreed not to purchase, redeem, or pay dividends or distributions on common stock or equivalents except under certain non-officer incentive agreements, and to reserve a number of authorized but unissued shares of common stock equal to 120% of the aggregate number of shares to effect the conversion of the Senior Notes, including accrued interest, and exercise of the warrants. Events of default in the agreements related to the Senior Notes include, among others, suspension from listing on an applicable trading market, the 2005 Registration Statement or the New Registration Statement fail to remain effective, and default on other Company indebtedness. Upon an event of default, the August Investors can declare all amounts under the Senior Notes due and payable.

The Company has also agreed that if the August Investors are unable to use either the 2005 Registration Statement or the New Registration Statement, because, among other reasons, it has lapsed or is suspended, as defined in the related agreement, then the Company will pay the August Investors an amount equal to one and one half percent (1.5%) of the original principal amount of the Senior Notes, in cash, for every thirty day period that such registration statement cannot be used. As of September 30, 2006, the Company is in compliance with the covenants of the Senior Notes.

The Company has agreed with the August Investors (i) that it will maintain at least $1.5 million in its bank accounts while the Senior Notes are outstanding; (ii) that they will have rights of first refusal on future financings within fourteen months after the effective date of the 2005 Registration Statement; and (iii) that it will be restricted from issuing certain types of debt and equity instruments while the Senior Notes are outstanding.

In accordance with SFAS No. 133, and related amendments and guidance, the conversion and prepayment feature are considered a derivative instrument and are required to the extent not already a free standing contract, to be bifurcated from the debt instrument and accounted for separately. In addition, to the extent the related debt instrument is outstanding, the warrant is accounted for as a liability due to the existence of certain provisions in the instrument. As a result, the Company recorded a total aggregate derivative liability of $2.4 million as of August 16, 2005. The derivative liabilities consist of the conversion and prepayment feature, and the warrants which were both valued at $1.2 million. Changes in the fair value of the derivative liabilities are recorded in the consolidated statement of operations. As of September 30, 2006, the derivative liabilities had a fair value of $36,000 and $10,000, for the conversion and prepayment feature and the warrants, respectively. The aggregate change in fair value of these derivatives decreased and accordingly, the Company recognized a benefit of $64,000 and $1.3 million for the three and nine months ended September 30, 2006, respectively, which is included in interest and other expense, net in the accompanying consolidated statements of operations.

The debt discount of $2.4 million is being accreted over the life of the Senior Notes using the effective interest rate method and is being recorded as additional interest expense in the statement of operations. The effective interest rate used to accrete the debt discount is 56.3% The Company recorded additional interest expense for the three and nine months ended September 30, 2006 of $308,000 and $1.1 million, respectively, related to this accretion. The unamortized debt discount at September 30, 2006 and December 31, 2005 was approximately $452,000 and $1.6 million, respectively. The Company incurred $684,000 of costs related to completing the private placement, which is included in other assets on the consolidated balance sheet. Included in the costs are $35,000 related to the issuance of 20,205 warrants to the placement agent. The deferred financing costs are being amortized using the effective interest method over the life of the Senior Notes. The net balance of the deferred financing costs as of September 30, 2006 and December 31, 2005 was approximately $159,000 and $491,000, respectively. For the three and

nine months ended September 30, 2006, the Company recorded $98,000 and $329,000, respectively, of interest expense related to the amortization of the deferred financing costs. At September 30, 2006, $23,000 of accrued interest related to the Senior Notes was included in accounts payable and accrued expenses in the consolidated balance sheet.

As outlined by the Senior Notes, the Company, at its discretion, may pay the monthly principal and interest payments in cash, common stock, or a combination of cash and common stock. The Company issued 1,058,046 shares of common stock during the nine months ended September 30, 2006 for the principal and interest payments. In October and November 2006, the Company made these payments with a combination of cash and its common stock and as a result, the Company has issued an additional 141,937 and 262,955 shares of common stock on October 2, 2006 and November 1, 2006, respectively, and paid $230,709 and $192,868, respectively. As of November 10, 2006, we had approximately 1.6 million shares of common stock remaining available for issuance under the New Registration Statement for payments on the Senior Notes.

Senior Subordinated Discount Note

On May 15, 2006, the Company entered into a Note Purchase Agreement (Purchase Agreement) with an institutional investor (the May Investor). Under the terms of the Purchase Agreement, the May Investor agreed to loan the Company $4.0 million and the Company agreed to issue to the May Investor a senior subordinated discounted promissory note in the principal amount of $5.3 million (the Discount Note). The difference between the loan amount and the principal amount has been recorded as a debt discount in the accompanying consolidated balance sheet.

Pursuant to the Purchase Agreement, the Company agreed to use commercially reasonable efforts to obtain the consent of the holders of the Senior Notes, to permit the Company to grant a subordinated lien and security interest in all of the Company s and its subsidiaries assets to the May Investor (the Consent).

The Company issued the Discount Note on May 18, 2006. Interest on the principal amount of the Discount Note accrues at 6.00% per annum payable quarterly in arrears, beginning July 2006 until the maturity date. The principal amount of the Discount Note will become due on the earlier of: (i) 18 months from the date of issuance; (ii) January 31, 2007, if the Company is unable to obtain the Consent; or (iii) the date on which the Company consummates a fundamental transaction, which is defined to include a transaction involving the sale of substantially all of its assets or any merger, consolidation, or similar transaction involving the transfer of greater than 50% of the Company s outstanding voting securities, any reclassification or change in the outstanding shares of the Company s common stock, other then a change of par value or as a result of a subdivision or combination or the Reverse Split, or any event or transaction or series of such that results in the Company s Board of Directors ceasing to constitute a majority of the Company s Board. The Company may prepay the Discount Note at any time. However, if the Company was not able to obtain the Consent by June 18, 2006, the interest rate would increase to 12% per annum (the Rate Increase). Although the Company was unable to obtain the Consent by June 18, 2006, the May Investor granted the Company a conditional waiver (the Conditional Waiver) to the Rate Increase if prior to July 18, 2006, the Company was able to enter into an agreement with a third party, satisfactory to the May Investor, with respect to certain potential liabilities. Because the Company was not able to enter into such agreement by July 18, 2006, pursuant to the Discount Note and the Conditional Waiver, the interest rate increased from 6% per annum to 12% per annum retroactively effective to June 18, 2006. The May Investor can declare the Discount Note due at any time after January 31, 2007, unless the Company obtains the Consent prior to that date. As a result, the obligations under the Discount Note have been reflected on our consolidated balance sheet as of September 30, 2006 in current portion of long-term debt because the obligations under the Discount Note could be declared due within one year. We are actively seeking the Consent from the holders of the Senior Notes. If we obtain the Consent before January 31, 2007, the maturity date of the Discount Note will be November 18, 2007. No assurance can be made that we will be able to obtain the Consent.

Furthermore, the Discount Note provides that upon the occurrence of certain events of default, including among others the failure to make a timely payment on the Discount Note or any other indebtedness in excess of $100,000, suffering an event of default under other indebtedness, bankruptcy, an uncovered final judgment being rendered against the Company exceeding $100,000, a going concern opinion being issued by the Company s independent registered public accounting firm, or the failure to maintain the listing of the Company s stock on a satisfactory exchange or market including the OTC Bulletin Board, the interest rate will increase to 14.00% per annum. In addition, if an event of default occurs due to bankruptcy, the Discount Note and accrued interest would automatically become due and payable. Upon all other events of default, the May Investor can declare the Discount Note and accrued interest automatically due and payable. As of September 30, 2006, we are in compliance with the terms of the Discount Note.

The terms of the Discount Note restricts the Company s ability to sell its assets without the written consent of the May Investor, incur indebtedness, make cash payments on existing indebtedness, pay dividends, and redeem outstanding shares.

The transaction resulted in net proceeds to the Company of approximately $3.7 million, after deducting the offering costs and fees. The Company intends to use these proceeds for working capital and general corporate purposes, subject to certain exceptions and limitations set forth in the Purchase Agreement.

The debt discount of $1.3 million is being amortized over the period ending on the earliest date the May Investor can call the Discount Note (which is January 31, 2007) using the effective interest rate method and is being recorded as additional interest expense in the statement of operations. The effective interest rate used to amortize the debt discount is 56.0%. The Company

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recorded additional interest expense for the three and nine months ended September 30, 2006 of $452,000 and $674,000, respectively, related to this amortization. The unamortized debt discount at September 30, 2006 was approximately $626,000. The Company incurred $324,000 of costs related to completing the private placement, which is included in other assets on the consolidated balance sheet. The deferred financing costs are being amortized using the effective interest method over the same period as the debt discount. The net balance of the deferred financing costs as of September 30, 2006 was approximately $185,000. The Company recorded $113,000 and $138,000 of interest expense related to the amortization of the deferred financing costs for the three and nine months ended September 30, 2006, respectively. At September 30, 2006, $171,000 of accrued interest related to the Discount Note was included in accounts payable and accrued expenses in the consolidated balance sheet.

(7) Commitments and Contingencies

Future minimum lease payments remaining under our capital and operating leases for fiscal years ending December 31 (in thousands):

	Lease Obligations		
	Operating	**Capital**	**Total**
2006 (a)	$ 247	$ 21	$ 268
2007	714	80	794
2008	536	38	574
2009	373	1	374
2010	365		365
	2,235	140	2,375
Less interest		(15)	(15)
Total	$ 2,235	$ 125	$ 2,360

(a) Reflects amounts payable over the last three months of 2006.

These future minimum lease payments include all leases for which we are contractually committed to make payments as of September 30, 2006.

The Company licenses software to its customers under written agreements. Each agreement contains the relevant terms of the contractual arrangement with the customers, and generally includes provisions for indemnifying the customers against losses, expenses, and liabilities from damages that may be awarded against the customer in the event the software is found to infringe upon certain intellectual property rights of a third party. The agreement generally limits the scope of and remedies for such indemnification obligations in a variety of industry-standard respects. The Company has not identified any losses that are probable under these provisions and, accordingly, no liability related to these indemnification provisions has been recorded.

The Company currently has employment agreements with certain senior executives that provide for a minimum level of salaries in 2006, and automatically renew each year unless either party gives at least thirty-days to one-year advance notice of non-renewal. The terms of these agreements include severance and health insurance coverage, ranging from three months to one year, as well as pro rated portions of target bonuses.

(8) Litigation

On June 12, 2001, a class action lawsuit was filed against us and several of our officers and directors in U.S. Federal Court for the Southern District of New York (the District Court). Also named as defendants were four underwriters involved in the issuance and initial public offering (IPO) of our common stock in February 1999. The complaint alleges violations of federal securities law based on, among other things, claims that the underwriters (i) awarded material portions of the initial shares to certain favored customers in exchange for excessive commissions and (ii) engaged in a practice known as laddering, whereby the clients or customers agreed that in exchange for IPO shares they would purchase additional shares at progressively higher prices after the IPO. With respect to Verticalnet, the complaint alleges that Verticalnet and its officers and directors failed to disclose in the prospectus and the registration statement the existence of these purported excessive commissions and laddering agreements. After the initial complaint was filed, several copycat complaints with nearly identical allegations were filed by other plaintiffs in the District Court. All of the suits were consolidated into a single amended complaint containing additional factual allegations concerning the events set forth in the original complaints filed with the District Court in April 2002. In October 2002, the District Court entered

an order dismissing, without prejudice, the claims against the individual Verticalnet officers and directors who had been named as defendants in the various complaints. In February 2003, the District Court entered an order denying a motion made by the defendants to dismiss the actions in their entirety, but granting the motion as to certain of the claims against some defendants. However, the District Court did not dismiss

any claims against Verticalnet. In June 2003, Verticalnet s counsel, with the approval of Verticalnet s directors, executed a memorandum of understanding on behalf of Verticalnet with respect to a proposed settlement of the plaintiffs claims against Verticalnet. The proposed settlement, if finally approved by the District Court, would result in, among other things, the dismissal of all claims against Verticalnet and its officers and directors. Under the present terms of the proposed settlement, Verticalnet would also assign its claims against the underwriters to the plaintiffs in the consolidated actions. In February 2005, the District Court preliminarily approved the proposed settlement. In April 2006, the District Court held a final fairness hearing on the proposed settlement but reserved its final approval.

On September 30, 2004, the Company was served with a complaint (the Complaint) filed against the Company and several of its former officers and directors in the U.S. District Court for the Eastern District of Pennsylvania in an action captioned Jodek Charitable Trust, R.A., Individually and as Assignee of Zvi Schreiber, LLC et al. (Jodek) v. Vertical Net Inc., et al., C.A. No. 04-4455 (Jodek Case). The Complaint alleged that, with regards to the issuance of the Company s stock to the plaintiff s predecessors in interest in connection with the Company s acquisition of Tradeum, Inc. in March 2000, the plaintiff was damaged by the defendants delays in registering stock, updating the registration of stock, releasing stock from lock-ups and releasing stock from escrows. On May 5, 2006, the Company was informed that its insurer was largely denying the Company s claim for coverage under the Company s directors and officers insurance policy (the D&O Policy).

On August 11, 2006, the Company and Jodek entered into a Settlement Agreement (the Settlement Agreement), that provided for the settlement of the Jodek Case. Pursuant to the Settlement Agreement: (i) the settlement amount was fixed at $5,563,000; (ii) the Company agreed to pay the balance of its $500,000 retention obligation under the D&O Policy (less than $100,000) to the plaintiff (which amount has been paid); (iii) the Company agreed to prosecute an action, at the plaintiff s expense, against the Company s insurer to require the insurer to pay the balance of the settlement amount for the benefit of plaintiff; and (iv) the plaintiff agreed to release the Company of all claims. Pursuant to the Settlement Agreement, the Company will only be required to pay the balance of the settlement amount ($5,563,000) if any of the Company s claim is collected from the insurer to the extent of the amount collected; therefore, this amount is not recorded as a liability in the accompanying consolidated balance sheet. On August 22, 2006, the U.S. District Court for the Eastern District of Pennsylvania entered an order approving the Settlement Agreement and entering it as an order of the Court.

On September 22, 2006, in accordance with the Settlement Agreement, the Company instituted an action in the U.S. District Court for the Eastern District of Pennsylvania captioned Verticalnet, Inc. v. U.S. Specialty Insurance Company at Civil Action No. 06-4245 (the Second Jodek Case). Pursuant to the Settlement Agreement, the attorney representing the Company in the Second Jodek Case was selected by and is being paid for solely by Jodek.

On May 9, 2006, CombineNet, Inc. (CombineNet) and Verticalnet entered into a Settlement Agreement and Release (the Settlement Agreement) that resolved certain litigation commenced by CombineNet. The Settlement Agreement provided, among other things, that (i) the Company pay CombineNet (a) $125,000 upon execution of the agreement; (b) $125,000 on July 31, 2006; and (c) beginning October 31, 2006, $50,000 per quarter for eight consecutive quarters; provided that this obligation will continue for so long as Verticalnet decides to continue offering certain optimization products; (ii) CombineNet granted Verticalnet a limited license to use the CombineNet s technology through July 2006 in order to complete existing certain contracts; (iii) Verticalnet would permit an expert to review Verticalnet s Advanced Sourcing RFX to determine whether certain elements of the RFX used or were derived from CombineNet s technology; (iv) Verticalnet would permit the expert to review certain future Verticalnet optimization products to determine whether the new products used or were derived from CombineNet s technology; and (v) that Verticalnet would pay the expert s fees, both for an original review and for the future reviews set forth in sections (iii) and (iv) above. On June 16, 2006, the expert rendered his final report, and found that neither Verticalnet s Advanced Sourcing RFX nor its new optimization products were derived from CombineNET s CEDL technology. During the nine months ended September 30, 2006, the Company recorded $730,000 in litigation and settlement costs for the Settlement Agreement and related costs. As of September 30, 2006, the Company has paid $250,000 of the total settlement obligation.

We are also a party to various lawsuits and claims that arise in the ordinary course of business. In the opinion of management, the ultimate resolutions with respect to all of the above actions will not have a material adverse effect on our financial position, liquidity, or results of operations.

(9) Capital Stock

At September 30, 2006, our amended and restated Articles of Incorporation provide us the authority to issue 21,428,571 shares of common stock and 10,000,000 shares of blank check preferred stock.

(10) Restructuring

During the nine months ended September 30, 2006, we incurred additional restructuring charges of $195,000 in connection with strategic and organizational initiatives designed to realign business operations, eliminate acquisition related redundancies, and reduce costs. The aggregate remaining restructuring accrual at September 30, 2006 was $8,000. The Company expects to complete all payments relating to this restructuring accrual within the next six months.

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The following table provides a summary by category and a roll-forward of the changes in the restructuring accrual for the nine months ended September 30, 2006 (in thousands):

	Accrual at December 31, 2005	Restructuring Charges	Cash Payments	Adjustments (a)	Accrual at September 30, 2006
Employee severance and related benefits	$ 5	$ 238	$ (199)	$ (43)	$ 1
Lease costs	60		(53)		7
	$ 65	$ 238	$ (252)	$ (43)	$ 8

(a) The adjustments represent a change in estimates related to various severance costs.

During the three and nine months ended September 30, 2005, we recorded $162,000 and $486,000, respectively, of restructuring charges in connection with strategic and organizational initiatives designed to realign business operations, eliminate acquisition related redundancies, and reduce costs.

The following table provides a summary by category and a roll-forward of the changes in the restructuring accrual for the nine months ended September 30, 2005 (in thousands):

	Accrual at January 1, 2005	Restructuring Charges	Cash Payments	Adjustments (a)	Accrual at September 30, 2005
Employee severance and related benefits	$	$ 422	$ (290)	$ 179	$ 311
Lease costs		64		46	110
	$	$ 486	$ (290)	$ 225	$ 421

(a) The adjustments represent accruals made on the opening balance sheet of Digital Union pertaining to employee severance and lease termination costs of $192,000 and $46,000, respectively. This was offset by a $13,000 adjustment for a change in estimate related to severance and related benefits costs.

(11) Share Based Compensation

Since 1996, the Company has established or acquired various long term incentive and equity compensation plans (Option Plans). The various Option Plans were established to provide additional incentives to our employees, non-employee directors, consultants, and advisors. The plans can grant various types of options, such as nonqualified and incentive stock options, as well as non-vested stock and restricted stock units (RSUs). Under these option plans approximately 1.1 million shares of common stock are reserved for issuance upon the exercise of options, including those outstanding at September 30, 2006. As of September 30, 2006 there were approximately 105,000 shares available to be granted under these plans.

The exercise prices for the options are determined by our board of directors and are generally equal to the fair market value of the common stock on the date of grant. Non-vested stock and restricted stock unit awards are issued at $0.01 per share and generally vest over a one- to four-year period. Generally, the options vest over a two- to four-year period after the date of grant and expire ten years after the date of grant. Option holders that terminate their employment generally forfeit all non-vested awards.

Stock Option Fair Value Information

The fair value of each option award is estimated on the date of grant using a Black-Scholes option valuation model that uses the assumptions noted in the following table. Expected volatility is based on the historical volatility of the price of the Company s stock. The Company also uses

historical data to estimate employee forfeiture rates. The expected life of options represents the period of time that options are expected to be outstanding. Starting in 2006, upon the adoption of SFAS 123R the Company began using the simplified method as prescribed in the SEC s Staff Accounting Bulletin No. 107, Share-Based Payments, to recalculate expected life, prior to January 1, 2006, the expected life of options was derived from historical information. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The fair values of the options

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granted during the three and nine months ended September 30, 2006 and 2005, were estimated using the Black-Scholes option-pricing model based on the following weighted average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Risk free interest rate	4.4%	4.2%	4.4%	3.8%
Expected life	5.3 years	1.8 years	5.4 years	1.9 years
Expected volatility	125.4%	125.4%	125.4%	128.0%
Expected dividend yield	0%	0%	0%	0%
Forfeiture rate	15.9%	15.9%	15.9%	14.3%

General Stock Option Information

A summary of option activity under our stock option plans for the nine months ended September 30, 2006 is as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value ($)
Options outstanding at January 1, 2006	**919,439**	**$ 36.37**		
Granted	76,871	2.75		
Exercised				
Forfeited	(81,340)	15.62		
Expired	(24,845)	17.49		
Options outstanding at September 30, 2006	**890,125**	**$ 35.89**	**6.7**	**$ 0**
Options exercisable at September 30, 2006	**707,602**	**$ 43.71**	**6.2**	**$ 0**

A summary of the status of the Company s unvested options as of September 30, 2006, and changes during the nine months ended September 30, 2006, is presented below:

	Options	Weighted Average Grant-Date Fair Value ($)
Unvested options at January 1, 2006	**261,030**	**$ 6.07**
Granted	76,871	2.19
Vested	(119,106)	7.60
Forfeited	(36,272)	5.11
Unvested options at September 30, 2006	**182,523**	**$ 3.63**

The weighted-average estimated grant date fair value of stock options granted during the three and nine months ended September 30, 2006 was $0.90 and $2.75, respectively. The weighted-average estimated grant date fair value of stock options granted during the three and nine months ended September 30, 2005 was $4.72 and $7.17, respectively. During the three and nine months ended September 30, 2006, the Company recorded $142,000 and $527,000, respectively of stock-based compensation expense associated with these stock option awards. As of September 30, 2006, there was approximately $537,000 of total unrecognized compensation cost, net of estimated forfeitures, related to stock options granted under our Option Plans which are expected to be recognized over a weighted average period of 1.1 years.

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Restricted Stock Units and Non-Vested Shares Information

Restricted stock units are converted into shares of common stock upon vesting on a one-for-one basis. The cost of these awards along with non-vested stock grants, are determined using the fair value of our common stock on the date of the grant and compensation expense is recognized over the vesting period. RSU and non-vested stock activity is summarized in the following table:

	Number	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value ($)
Restricted stock units and non-vested shares at January 1, 2006	**135,723**		
Granted	185,085		
Exercised	(179,627)(1)		
Forfeited	(24,259)		
Restricted stock units and non-vested shares at September 30, 2006	**116,922**	**8.8**	**$ 92,368**

(1) The intrinsic value of exercised non-vested shares during 2006 was $373,100.

A summary of the status of the Company s unvested restricted stock units and non-vested shares as of September 30, 2006, and changes during the nine months ended September 30, 2006, is presented below:

	Number	Weighted Average Grant-Date Fair Value ($)
Unvested restricted stock units and non-vested shares outstanding at January 1, 2006	**126,717**	**$ 7.83**
Granted	185,085	3.74
Vested	(229,248)	5.45
Forfeited	(24,259)	4.06
Unvested restricted stock units and non-vested shares outstanding at September 30, 2006	**58,295**	**5.78**

During the three and nine months ended September 30, 2006, the Company granted 8,064 and 185,085 shares, respectively, of non-vested common stock to executive officers and certain employees with a fair value of approximately $5,000 and $692,000, respectively. These amounts are being amortized on a straight line basis over the vesting period of each grant. During the three and nine months ended September 30, 2006, the Company recorded $208,000 and $887,000 respectively, of stock-based compensation expense associated with non-vested stock grants. As of September 30, 2006, there was approximately $235,000 of unrecognized compensation cost related to unvested restricted stock units and non-vested shares. The cost is expected to be recognized over a weighted-average period of 0.9 years.

During the three and nine months ended September 30, 2005, the Company granted 38,555 and 92,361 shares, respectively, of non-vested common stock to executive officers and certain employees with a fair value of approximately $166,000 and $542,000, respectively. These amounts are being amortized on a straight line basis over the vesting period of each grant. During the three and nine months ended September 30, 2005, the Company recorded $211,000 and $628,000, respectively, of stock-based compensation expense associated with non-vested stock grants.

As of September 30, 2006 approximately 59,000 restricted stock units have vested but the related shares are not issued as a result of individual elections made at the grant date to defer distribution until a later date.

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Stock-based Compensation Expense

Total stock-based compensation was recorded for the three and nine months ended September 30, 2006 and 2005, respectively, to various operating expense categories as follows:

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Cost of revenues	$ 24	$ 41	$ 238	$ 84
Research and development	46	8	184	26
Sales and marketing	105	71	347	235
General and administrative	175	91	645	283
	$ 350	$ 211	$ 1,414	$ 628

The Company s operating and net loss for the three and nine-month periods ended September 30, 2006 were $142,000 and $527,000 higher than they would have been pursuant to the Company s previous accounting method for stock-based compensation, respectively. The adoption of Statement No. 123R increased basic and diluted loss per share by $0.02 and $0.07 for the three and nine months ended September 30, 2006, respectively.

(12) Segment Information

The Company follows SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, which establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available that is regularly evaluated by the chief operating decision maker (CODM) in deciding how to allocate resources and in assessing performance.

The Company has one operating segment. The Company markets its products in the United States of America and in foreign countries through its direct sales force and indirect sales channels. The CODM evaluates resource allocation decisions and the performance of the Company based upon consolidated revenues and expense financial information. The CODM does not receive financial information about revenue and expense allocations on a disaggregated basis.

Information regarding revenues for the three and nine months ended September 30, 2006 and 2005 and long-lived assets (excluding goodwill and intangibles) in geographic areas as of September 30, 2006 and December 31, 2005, is as follows (in thousands):

	Three months ended September 30, 2006	Three months ended September 30, 2005	Nine months ended September 30, 2006	Nine months ended September 30, 2005
Revenues:				
United States	$ 3,411	$ 4,351	$ 10,295	$ 13,841
International	762	547	1,979	1,377
Total revenues	$ 4,173	$ 4,898	$ 12,274	$ 15,218

	September 30, 2006	December 31, 2005
Long-lived Assets:		
United States	$ 1,525	$ 1,965
International	67	91
	$ 1,592	$ 2,056

Revenues are attributed to countries based on the location of the Company s subsidiaries providing the product or services. The Company s international revenues were derived primarily from sales in Europe.

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(13) Interest and Other Expense (Income), Net

Interest and other expense (income), net is comprised of the following (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Interest expense, net	$ 1,199	$ 306	$ 2,707	$ 254
Change in fair value of derivative liabilities	(64)	(663)	(1,265)	(663)
Write-down related to cost method investment				364
Transaction loss (gain)	9	(2)	47	(15)
Other expenses (income), net	1	(10)		(11)
	$ 1,145	$ (369)	$ 1,489	$ (71)

As a result of certain features contained in our Senior Notes and related warrants, we were required under U.S. generally accepted accounting principles to record derivative liabilities, which have an aggregate fair value of $46,000 and are recorded on the balance sheet as of September 30, 2006. For each subsequent quarter, we are required to revalue the derivative liabilities and the change from the prior period will be recorded as a non-cash charge or benefit in the consolidated statement of operations. During the three and nine months ended September 30, 2006, we recorded a non-cash benefit of $64,000 and $1.3 million, respectively. Changes in the fair value of the derivative liabilities are primarily measured using the Black-Scholes valuation model. The fair value of the derivative liabilities are directly affected by the change in the market value of our stock.

At the time of the issuance of the Senior Notes, we recorded a debt discount of $2.4 million related to the derivative liabilities. This amount is being amortized over the life of the notes and recorded as additional interest expense. During the three and nine months ended September 30, 2006, we recorded $308,000 and $1.1 million, respectively, as interest expense related to this amortization.

At the time of the issuance of the Discount Note, we recorded a debt discount of $1.3 million. This amount is being amortized over the life of the notes and recorded as additional interest expense. During the three and nine months ended September 30, 2006, we recorded $452,000 and $674,000, respectively, as interest expense related to this amortization.

During the three and nine months ended September 30, 2006, the Company also recorded $211,000 and $467,000, respectively, of interest expense related to the amortization of deferred financing costs related to the Senior Notes and the Discount Note.

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

The information in this report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Any statements contained in this report that are not statements of historical fact may be deemed forward-looking statements. Words such as may, might, will, would, should, could, project, estimate, pro forma, predict, potential, strategy, anticipate, plan to, believe, continue, intend, expect, and words of similar expression (including the negative of any of the foregoing) are intended to identify forward-looking statements. Additionally, forward-looking statements in this report include statements relating to the design, development, and implementation of our products; the strategies underlying our business objectives; the benefits to our customers, and their trading partners, of our products; our liquidity and capital resources; and the impact of our acquisitions and investments on our business, financial condition, and operating results.

Our forward-looking statements are not meant to predict future events or circumstances and may not be realized because they are based upon current expectations that involve risks and uncertainties. Actual results and the timing of certain events may differ materially from those currently expected as a result of these risks and uncertainties. Factors that may cause or contribute to a difference between the expected or desired results and actual results include, but are not limited to, the availability of and terms of equity and debt financing to fund our business; our reliance on the development of our enterprise software business; our ability to continue to remain listed on the Nasdaq Capital Market; competition in our target markets; economic conditions in general and in our specific target markets; our ability to use and protect our intellectual property; and our ability to attract and retain qualified personnel, as well as the risks discussed in Part II , Item 1A of this report entitled Risk Factors. Given these uncertainties, investors are cautioned not to place undue reliance on our forward-looking statements. We disclaim any obligation to update these factors or to announce publicly the results of any revisions to any of the forward-looking statements contained in this report to reflect future events or developments.

Company Overview

We are a provider of On-Demand Supply Management solutions to companies ranging in size from mid-market to the Global 2000. We provide a full scope of Supply Management software, services, and domain expertise in areas that include: Program Management, Spend Analysis, eSourcing, Contract Management, and Supplier Performance Management. Our solutions provide our clients with the visibility, insight and control required to identify, realize, and sustain value from supply management initiatives.

Our software customers license our software pursuant to either a perpetual license or a time-based license. Our software is licensed by module, with our customers selecting from modules that include: Spend Manager, Program Manager, Negotiation Manager, Contract Manager, and Performance Manager. Verticalnet employs technical consultants to provide project management and training during software implementation. In addition to traditional software installation and Application Service Provider (ASP) hosting, Verticalnet offers the majority of its software products in an On-Demand delivery model. On-Demand delivery enables our customers to pay a single annual fee that includes software license, maintenance, application hosting, customer/community support, and training. The Company believes that its On-Demand delivery model mitigates the software implementation costs for its customers, and reduces the obstacles to a successful supply management initiative.

In addition to implementation services, our consultants provide customers with supply management business process consulting, primarily in the areas of Spend Analysis and Collaborative Sourcing. Our customers typically pay for professional services at an hourly rate for the time it takes us to complete the project. Most professional services engagements also include short-term licenses of Verticalnet technology required to complete the engagement. Examples of such technology include our Advanced Bid Collection and Bid Analysis Optimization software.

In addition to our packaged applications and implementation services, Verticalnet offers custom software development for customers that desire to build additional supply management capabilities. Verticalnet s Solution Center works with clients to define custom development requirements and build out the required functionality. Verticalnet offers a flexible software platform that enables rapid, cost effective custom development for customers with advanced, complex requirements.

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RESULTS OF CONTINUING OPERATIONS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005

The following table sets forth statement of operations data expressed as a percentage of total revenues for the periods indicated (some items may not add due to rounding):

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Revenues:				
Software and software related	56.1%	32.9%	47.0%	31.0%
Services	43.9%	67.1%	53.0%	69.0%
Total revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues:				
Cost of software and software related	12.7%	12.8%	13.9%	13.7%
Cost of services	25.1%	38.2%	33.7%	37.1%
Amortization of acquired technology and customer contracts	6.5%	5.5%	6.3%	4.9%
Total cost of revenues	44.3%	56.5%	53.8%	55.8%
Gross profit	55.7%	43.5%	46.2%	44.2%
Operating expenses:				
Research and development	28.8%	37.4%	33.2%	34.8%
Sales and marketing	39.1%	44.0%	44.5%	40.6%
General and administrative	37.1%	31.2%	39.8%	29.6%
Litigation and settlement costs	0.1%	3.1%	8.4%	1.3%
Restructuring charges (reversals)	(0.5%)	3.0%	1.6%	3.1%
Impairment charge for goodwill			80.5%	
Amortization of other intangible assets	4.8%	7.0%	5.4%	6.4%
Total operating expenses	109.4%	125.8%	213.4%	115.8%
Operating loss	(53.7%)	(82.3%)	(167.1%)	(71.5%)
Interest and other expense (income), net	27.4%	(7.5%)	12.1%	(0.5%)
Net loss	(81.1%)	(74.7%)	(179.3%)	(71.1%)

EMPLOYEE HEADCOUNT BY CLASSIFICATION

	September 30,					
	2006			2005		
	Employees	Dedicated Offshore Consultants	Total	Employees	Dedicated Offshore Consultants	Total
Cost of revenues	35	4	39	54		54
Research and development	24	23	47	38	35	73
Sales and marketing	25		25	31		31
General and administrative	18		18	27		27

Total	102	27	129	150	35	185

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Revenues

(in thousands)	Three months ended September 30, 2006	2005	Difference $	%	Nine months ended September 30, 2006	2005	Difference $	%
Software and software related	$ 2,343	$ 1,609	$ 734	45.6%	$ 5,774	$ 4,721	$ 1,053	22.3%
Services	1,830	3,289	(1,459)	(44.4%)	6,500	10,497	(3,997)	(38.1%)
Total revenues	$ 4,173	$ 4,898	$ (725)	(14.8%)	$ 12,274	$ 15,218	$ (2,944)	(19.3%)

Revenue Concentration

As of and for