

Selected Financial Data

The statement of operations data set forth below for the years ended December 31, 1998, 1999 and 2000 and the balance sheet data as of December 31, 1999 and 2000 have been derived from audited financial statements. The statement of operations data for the period ended December 31, 1996 and 1997 and the balance sheet data as of December 31, 1996, 1997 and 1998 are derived from audited financial statements that do not appear in this report.

You should read the selected financial data set forth below with the financial statements and related notes and with "Management's Discussion and Analysis of Financial Condition and Results of Operations," which are included elsewhere in this report.

(In Thousands, Except Share and Per Share Data)	Year Ended December 31,				
	2000	1999	1998	1997	1996
<i>Statement of Operations Data</i>					
Net revenues	\$ 39,866	\$ 12,916	\$ 1,143	\$ 110	\$ —
Cost of revenues	7,028	1,818	428	148	—
Gross profit (loss)	32,838	11,098	715	(38)	—
Operating expenses					
Sales and marketing	41,607	17,838	2,494	1,202	253
Product development	7,764	4,503	1,217	719	131
General and administrative, exclusive of compensation related to stock options	18,885	5,890	2,350	766	499
Compensation related to stock options	3,960	—	—	—	—
Total operating expenses	72,216	28,231	6,061	2,687	883
Loss from operations	(39,378)	(17,133)	(5,346)	(2,725)	(883)
Interest income (expense), net	138	265	40	(3)	9
Amortization of debt discount	—	—	(435)	(4)	—
Net loss	\$ (39,240)	\$ (16,868)	\$ (5,741)	\$ (2,732)	\$ (874)
Deemed dividend representing the beneficial conversion feature of preferred stock	(19,868)	—	—	—	—
Loss applicable to common shareholders	\$ (59,108)	\$ (16,868)	\$ (5,741)	\$ (2,732)	\$ (874)
Historical loss per common share, basic and diluted	\$ (1.63)	\$ (0.57)	\$ (0.27)	\$ (0.15)	\$ (0.06)
Weighted average shares used to compute historical basic and diluted loss per common share	36,313,759	29,804,681	21,547,177	18,266,572	13,697,334
<i>Balance Sheet Data</i>					
Cash and cash equivalents	\$ 7,042	\$ 17,489	\$ 4,895	\$ 64	\$ 449
Working capital (deficit)	(1,624)	15,703	3,788	(886)	283
Total assets	29,150	29,590	6,371	353	466
Long-term debt, including current portion	4,389	878	300	241	300
Total shareholders' equity (deficit)	9,742	19,120	4,594	(775)	(4)

Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion of our financial condition and results of operations with the financial statements and the related notes included elsewhere in this report. This discussion contains forward-looking statements based on our current expectations, assumptions, estimates and projections. These forward-looking statements involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of numerous factors, many of which are described in the "Factors That May Affect Future Results" section and elsewhere in this report. We are under no duty to update any of the forward-looking statements after the date of this report to conform these statements to actual results, unless required by applicable securities laws.

Overview

CoolSavings is a comprehensive e-marketing solution for both offline and online advertisers that provides a broad range of branded consumer promotional incentives and data mining technology to help leading brick and mortar retailers, e-tailers and consumer packaged good manufacturers build profitable one-to-one relationships. With a database of more than 13 million registered members (as of March 1, 2001), CoolSavings supplies marketers with a single resource for accessing and engaging a dynamic group of shoppers. Under our established brand, advertisers can deliver, target and track a wide array of incentives, including printed and electronic coupons, personalized e-mails, rebates, samples, sales notices, gift certificates, contests and banner advertisements to promote sales of products or services in stores or online.

We were incorporated in December 1994 as Interactive Coupon Marketing Group, Inc. and changed our corporate name to coolsavings.com inc. in November 1998. From inception through February 1997, our primary activities consisted of initiating sales and marketing efforts, developing our business model, building our software and hardware infrastructure, developing and protecting our intellectual property, raising capital and recruiting employees. We launched our Web site in February 1997 and thereafter began generating revenues.

How We Generate Revenue

E-marketing Services Revenue

We generate substantially all of our revenues primarily by providing online marketing, or e-marketing services to our advertisers.

E-marketing services revenue also includes barter transactions, where we exchange advertising space on our Web site or in e-mails for reciprocal advertising space or traffic on other Web sites. Revenue from these barter transactions is recorded at the estimated fair value of the advertisements delivered and is recognized when the advertisements are included on our Web site or in our e-mails. Prior to January 2000, barter transactions were recorded at the fair value of the goods or services provided or received, whichever was more readily determinable in the circumstances. In January 2000, the Company adopted Emerging Issues Task Force ("EITF") 99-17, "Accounting for Advertising Barter Transactions." In accordance with EITF 99-17, barter transactions have been valued based on similar cash transactions which have occurred within six months prior to the date of the barter transaction. For the year ended December 31, 2000, barter revenue was less than 6% of net revenues.

We charge our advertisers on a variety of bases, the most common of which include:

- *the number of offers delivered to members, commonly sold on a cost per thousand, or CPM, basis;*
- *the number of times members click on an incentive linking the member to the advertiser's Web site (known as a click-through response);*
- *the number of purchases made or qualified leads generated;*
- *the number of registered members in our database.*

Our pricing depends upon a variety of factors, including, without limitation, the degree of targeting, the duration of the advertising contract and the number of offers delivered. The degree of targeting refers to the number of identified household or member attributes, such as gender, age, or product or service preferences, used to select the audience for an offer. Generally, the rates we charge our advertisers increase as the degree of targeting and customization increases. Revenues

Management's Discussion and Analysis
How We Generate Revenue
E-marketing Services Revenue (continued)

subject to time-based contracts are recognized ratably over the duration of the contract. For contracts based on certain performance or delivery criteria, revenues are recognized in the month performance is delivered to the customer. Most of our advertising contracts have stated terms of less than one year and may include earlier termination provisions. In 2000, our largest advertiser accounted for 10.3% of our revenues and our top five advertisers together accounted for approximately 27.7% of our revenues.

Our revenues for each period depend on a number of factors, including the number of advertisers sending promotional offers to our members, the size of our membership base and the responsiveness of our members to each promotion. We believe that our revenues will be subject to seasonal fluctuations in accordance with general patterns of retail advertising spending, which is typically highest during the fourth quarter. In addition, expenditures by advertisers tend to be cyclical, reflecting overall general economic conditions and consumer buying patterns. If purchasing patterns or timing of purchasing by advertisers were to change, our operations and quarter-to-quarter comparisons could be materially affected.

Licensing Revenue

We license portions of our intellectual property, including our issued patents, to third parties. Approximately 2% of our revenues were generated from royalty and license fees and other miscellaneous sources during the year ended December 31, 2000.

Expenses

Cost of Revenues

Our cost of revenues consists primarily of Internet connection charges, Web site equipment depreciation, salaries of operations personnel, fulfillment costs related to member loyalty incentives and other related operations costs. In the first three quarters of fiscal year 2000 we expanded our Web server capacity and our investment in data mining tools and personnel.

Sales and Marketing

Sales and marketing expenses include salaries, sales commissions, employee benefits, travel and related expenses of our direct sales force, advertising and promotional expenses, marketing, and sales support functions. Marketing costs associated with increasing our member base are expensed in the period incurred. In the fourth quarter of fiscal year 2000 we began to anticipate the slowing economy and implemented a new cost reduction plan. This plan included a significant decrease in offline marketing expenditures and a reduction in salaried personnel and third-party technical consultants. We believe that this plan will significantly reduce operating expenses and have a positive effect on cash flow.

Product Development

Product development costs include expenses for the development of new or improved technologies designed to enhance the performance of our service, including the salaries and related expenses for our technology department, as well as costs for contracted services and equipment.

General and Administrative

General and administrative expenses include salaries, employee benefits and expenses for our executive, finance, legal and human resources personnel. In addition, general and administrative expenses include fees for professional services and occupancy costs.

Results of Operations

We have incurred significant losses since our inception. As of December 31, 2000, our accumulated deficit was approximately \$60.4 million. While we expect to continue to incur significant operating losses during the first half of 2001, we have set a goal to be profitable in the second half of fiscal year 2001. Even though we are experiencing a decrease in top-line revenue as a result of the slowing economy, we believe that the actions we have taken to reduce expenses coupled with our emphasis on cost control should permit us to achieve

Management's Discussion and Analysis
Expenses
Results of Operations (continued)

that goal. There can be no assurance, however, that we will be successful in achieving our profitability goal. See "Liquidity and Capital Resources" below, and "Item 1. Business—Factors That May Affect Future Results" as set forth in our form 10-K for the year ended December 31, 2000.

	Year Ended December 31,		
	2000	1999	1998
Net revenues	100.0%	100.0%	100.0%
Cost of revenues	17.6	14.1	37.4
Gross profit (loss)	82.4	85.9	62.6
Operating expenses:			
Sales and marketing	104.4	138.1	218.3
Product development	19.5	34.9	106.5
General and administrative, exclusive of compensation related to stock options	47.4	45.6	205.6
Compensation related to stock options	9.9	—	—
Total operating expenses	181.2	218.6	530.4
Loss from operations	(98.8)	(132.7)	(467.8)
Other income (expense):			
Interest income (expense), net	1.8	2.1	3.5
Amortization of debt discount	—	—	(38.1)
Interest expense representing beneficial conversion feature of subordinated notes	(1.4)	—	—
Total other income (expense)	0.4	2.1	(34.6)
Net loss	(98.4)	(130.6)	(502.4)
Deemed dividend representing the beneficial conversion feature of preferred stock	(49.9)	—	—
Net loss applicable to common shareholders	(148.3)%	(130.6)%	(502.4)%

Year Ended December 31, 2000 Compared to Year Ended December 31, 1999

Net Revenues

Net revenues increased 209% to \$39.9 million in 2000 from \$12.9 million in 1999. The revenue increase was attributable to our continued ability to rapidly expand our member base, to sign up additional offline and online advertisers, and to expand programs with existing advertisers into more comprehensive promotion programs, including targeted e-mail, category newsletters, printable coupons, e-coupons, savings notices, rebates, lead generation, loyalty points and free samples. Our member base grew to approximately 12 million registered members at December 31, 2000 from approximately 5.0 million at December 31, 1999.

Cost of Revenues and Gross Profit

Cost of revenues increased to \$7.0 million in 2000, from \$1.8 million in 1999. Gross profit decreased as a percentage of net revenues to 82.4% in 2000, from 85.9% in 1999. The absolute dollar increase in cost of revenues was primarily due to increased costs for incentive points and gift certificates, costs related to building our server and networking infrastructure in response to the growth in activity by our members, and the hiring of additional operations personnel to service our increased advertiser base.

Operating Expenses

Sales and Marketing — Sales and marketing expenses increased to \$41.6 million, or 104% of net revenues in 2000, from \$17.8 million, or 138% of net revenues, in 1999. The \$23.8 million increase in sales and marketing expenses was primarily due to increased expenses associated with promotional and marketing efforts, member acquisition costs, the hiring of additional sales and marketing personnel, and increased sales commissions. These marketing efforts enabled us to more than double our registered member base. We spent approximately \$30.2 million for combined online and offline advertising in 2000, up from approximately \$13.5 million in 1999. Throughout fiscal year 2000, we were able to achieve significant reductions in the average cost of registering new members. This was primarily due to our brand awareness and our ability to negotiate lower cost per acquisition rates with other Web sites. We expect these factors will permit us to continue to pursue a more cost effective customer acquisition strategy, even with reduced emphasis on more costly offline advertising. Sales and marketing expenses as a percentage of net revenues decreased due to the growth in net revenues.

Product Development — Product development expenses increased to \$7.8 million, or 19.5% of net revenues, in 2000, from \$4.5 million, or 34.9% of net revenues, in 1999. On July 1, 2000, we adopted the provisions of EITF 00-2 ("Accounting for Web Site Development Costs") and capitalized \$2.7 million of Web site development costs incurred on projects in process at December 31, 2000. For prior periods through June 30, 2000, all product development expenditures were expensed as incurred. The absolute dollar increase in product development expenses was primarily due to

Management's Discussion and Analysis

Quarterly Financial Data

The following are unaudited quarterly results:

	For the three months ended			
	March 31, 2000	June 30, 2000	September 30, 2000	December 31, 2000
Net revenues	\$ 8,086,000	\$ 8,948,000	\$ 11,294,000	\$ 11,538,000
Operating expenses	15,720,000	17,945,000	18,913,000	19,637,000
Loss from operations	(8,702,000)	(10,360,000)	(9,821,000)	(10,495,000)
Loss applicable to common shareholders (a)	(13,595,000)	(25,574,000)	(9,534,000)	(10,405,000)
Weighted average shares outstanding	31,729,705	35,281,040	39,093,660	39,093,660
Basic and diluted earnings per share	(0.43)	(0.72)	(0.24)	(0.27)

	March 31, 1999	June 30, 1999	September 30, 1999	December 31, 1999
	Net revenues	\$ 890,000	\$ 2,075,000	\$ 3,276,000
Operating expenses	3,328,000	4,229,000	7,659,000	13,015,000
Loss from operations	(2,694,000)	(2,497,000)	(4,799,000)	(7,143,000)
Loss applicable to common shareholders	(2,624,000)	(2,392,000)	(4,725,000)	(7,127,000)
Weighted average shares outstanding	25,249,484	30,488,448	31,681,249	31,707,949
Basic and diluted earnings per share	(0.10)	(0.08)	(0.15)	(0.23)

(a) Loss applicable to common shareholders is increased by \$4,967,000 and \$14,901,000 related to a deemed dividend representing the beneficial conversion feature of preferred stock in the quarters ended March 31, 2000 and June 30, 2000, respectively.

Quantitative and Qualitative Disclosure About Market Risk

We had no holdings of derivative financial or commodity instruments at December 31, 2000. However, we are exposed to financial market risks associated with fluctuations in interest rates. Because all of the amounts in our portfolio or related income have expected maturities of three months or less, we believe that the fair value of our investment portfolio or related income would not be significantly impacted by increases or decreases in interest rates due mainly to the short-term

nature of our investment portfolio. If market rates were to increase immediately by 10 percent from levels on December 31, 2000, the fair value of this investment portfolio would decline by an immaterial amount. A sharp decline in interest rates could reduce future interest earnings of our investment portfolio. If market rates were to decrease immediately by 10 percent from levels on December 31, 2000, the resultant decrease in interest earnings of our investment portfolio would not have a material impact on our earnings as a whole. The Company has both fixed and variable rate debt as described in Note 5a.

Balance Sheets

<i>Assets</i>	December 31, 2000	December 31, 1999
<i>Current assets</i>		
Cash and cash equivalents	\$ 7,041,501	\$ 17,488,788
Restricted cash	28,000	95,352
Accounts receivable, net of allowance of \$1,318,097 and \$118,154 at December 31, 2000 and 1999, respectively	9,329,761	4,381,463
Prepaid advertising	193,829	2,787,327
Prepaid assets	528,676	290,103
Other assets	661,697	498,137
Total current assets	17,783,464	25,541,170
Property and equipment	9,444,645	3,494,784
Capitalized software costs	1,489,913	1,489,913
Capitalized Web site costs	2,667,633	—
Total	13,602,191	4,984,697
Less accumulated depreciation and amortization	(2,912,914)	(935,862)
	10,689,277	4,048,835
Intangible assets, patents and licenses, net of accumulated amortization of \$147,914 at December 31, 2000	677,086	—
Total assets	\$ 29,149,827	\$ 29,590,005
<i>Liabilities</i>		
<i>Current liabilities</i>		
Accounts payable, including amounts due to related parties of \$180,300 and \$24,944 at December 31, 2000 and 1999, respectively	\$ 6,730,244	\$ 2,344,841
Cash overdraft	1,335,333	—
Accrued marketing expense	2,289,015	1,057,149
Accrued compensation	2,229,404	31,294
Accrued expenses, including amounts due to related parties of \$34,542 and \$91,292 at December 31, 2000 and 1999, respectively	1,062,088	604,674
Other accrued liabilities	220,116	139,757
Deferred revenue	1,151,902	417,974
Current maturities of long-term debt	1,728,380	246,601
Long-term debt reclassified as currently payable	2,661,010	—
Convertible subordinated notes payable, including \$3,561,569 due to related parties	—	4,996,369
Total current liabilities	19,407,492	9,838,659
Long-term debt, less current maturities	—	631,831
Commitments and contingencies (Note 6)		
<i>Shareholders' Equity</i>		
Series A convertible preferred stock, no par value, 10,000,000 and 5,000 shares authorized at December 31, 2000 and 1999, respectively, zero and 2,197.650 shares issued and outstanding at December 31, 2000 and 1999, respectively (Liquidation preference of \$9,100.63 per share)	—	—
Common stock, no par value, 100,000,000 and 69,000,000 shares authorized at December 31, 2000 and 1999, respectively, 39,093,660 and 31,715,449 shares issued and outstanding at December 31, 2000 and 1999, respectively	73,658,743	27,844,658
Additional paid-in capital	(47,244)	15,204,073
Accumulated deficit	(60,351,872)	(21,111,924)
Notes receivable from related parties	(3,517,292)	(2,817,292)
Total shareholders' equity	9,742,335	19,119,515
Total liabilities and shareholders' equity	\$ 29,149,827	\$ 29,590,005

Statement of Operations

	For the Year Ended December 31,		
	2000	1999	1998
<i>Revenue</i>			
E-marketing services	\$ 39,048,978	\$ 12,908,534	\$ 1,142,819
License royalties	816,820	7,198	—
Net revenues	39,865,798	12,915,732	1,142,819
Cost of revenues	7,028,143	1,817,444	427,769
Gross profit	32,837,655	11,098,288	715,050
<i>Operating Expenses</i>			
Sales and marketing	41,607,341	17,837,722	2,494,395
Product development	7,763,656	4,503,223	1,217,101
General and administrative, exclusive of compensation related to stock options	18,884,707	5,890,193	2,349,725
Compensation related to stock options	3,959,565	—	—
Total operating expenses	72,215,269	28,231,138	6,061,221
Loss from operations	(39,377,614)	(17,132,850)	(5,346,171)
<i>Other Income (Expense)</i>			
Interest and other income	1,157,532	492,971	88,322
Interest expense	(464,719)	(228,500)	(48,517)
Amortization of debt discount	—	—	(434,894)
Interest expense representing beneficial conversion feature of subordinated notes	(555,147)	—	—
Total other income (expense)	137,666	264,471	(395,089)
Loss before income taxes	(39,239,948)	(16,868,379)	(5,741,260)
Income taxes	—	—	—
Net loss	(39,239,948)	(16,868,379)	(5,741,260)
Deemed dividend representing the beneficial conversion feature of preferred stock	(19,867,723)	—	—
Loss applicable to common shareholders	\$(59,107,671)	\$(16,868,379)	\$(5,741,260)
Basic and diluted net loss per share	\$ (1.63)	\$ (0.57)	\$ (0.27)
Weighted average shares used in the calculation of basic and diluted net loss per share	36,313,759	29,804,681	21,547,177

The accompanying notes are an integral part of the financial statements.

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies

a. The Company — The Company provides a comprehensive e-marketing solution for both offline and online advertisers that provides a broad range of branded consumer promotional incentives and data mining technology to help leading brick and mortar retailers, e-tailers and consumer packaged good manufacturers build profitable one-to-one relationships. Under our established brand, advertisers can deliver, target and track a wide array of incentives, including printed and electronic coupons, personalized e-mails, rebates, samples, sales notices, gift certificates, contests and banner advertisements to promote sales of products or services in stores or online.

In November 1998, the Company changed its corporate name from Interactive Coupon Marketing Group, Inc. to coolsavings.com inc.

These financial statements are prepared on a going-concern basis which assumes that the Company will realize its assets and discharge its liabilities in the normal course of business. The Company's ability to meet its obligations in the ordinary course of business is dependent upon its ability to establish profitable operations or raise additional financing through public or private equity financing, bank financing, or other sources of capital. During 1999, the Company raised approximately \$33.0 million from sales of common stock, preferred stock and convertible subordinated notes. In January 2000, the Company obtained a credit facility that originally provided for borrowings of up to \$6.5 million, which was amended in October 2000 to provide for up to an additional \$3.5 million in borrowings. In May 2000 the Company completed an initial public offering of shares of its common stock resulting in proceeds to the Company of approximately \$19.6 million, after deducting underwriters' discounts and commissions and other related offering expenses.

b. Profitability Uncertain and Liquidity Constraints — The Company has sustained significant net losses and negative cash flows from operations since inception. At December 31, 2000, the Company had negative working capital. In addition, the Company is not in compliance with certain covenants of its credit facilities with lenders. During 2000, the Company utilized approximately \$25.5 million of cash in its operations and had cash and cash equivalents of \$7.0 million at December 31, 2000.

The Company is seeking additional sources of financing to supplement amounts contributed by its shareholders (see Note 11) and expects to obtain the necessary financing to successfully execute its business plan, however, there can be no assurance that the Company will obtain necessary financing. Management plans to generate positive cash flows from operations and has implemented cost reductions in marketing, general and administrative, and technology expenses (see Note 11). Current market conditions are significantly affecting the Company's operating results. The ultimate recoverability of property and equipment and other assets is dependent upon, among other things, the success of the cost reductions and sustained revenue growth, the attainment of which cannot presently be assured. Since there is no assurance that management will complete their plans, there is substantial doubt about the Company's ability to continue as a going concern. The financial statements do not include any adjustments that may result from this outcome of this uncertainty.

c. Cash and Cash Equivalents — The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. Cash equivalents consist primarily of deposits in money market funds and certificates of deposit. Checks issued but not presented to the banks for payment may create negative book balances. Such negative cash balances are recorded in "Cash overdraft" in the accompanying balance sheets.

d. Concentration of Credit Risk — Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash and cash equivalents and accounts receivable. Cash and cash equivalents are deposited with high credit quality financial institutions. The Company's accounts receivable are derived from revenue earned from customers located primarily in the U.S. and are denominated in U.S. dollars. For the year ended December 31, 2000, the Company had one customer that accounted for approximately 10.3% of net revenues. For the years ended December 31, 1999 and 1998, there were no customers accounting for more than 10% of net revenues. Additionally, no customers accounted for more than 10% of the Company's net receivables for any period presented.

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies (continued)

e. Fair Value of Financial Instruments — The Company's financial instruments, including cash and cash equivalents, accounts receivable and accounts payable, are carried at cost, which approximates their fair value because of the short-term maturity of these instruments. The carrying value for all long-term debt outstanding at the end of all periods presented approximates fair value.

f. Property and Equipment — Property and equipment are recorded at cost. Depreciation and amortization are computed using primarily the straight-line method over the estimated useful lives of the assets. Useful lives for computer hardware and software are 3 to 5 years, and 5 to 7 years for furniture and fixtures. Leasehold improvements are amortized over the term of the lease or the estimated useful life, whichever is shorter. Upon sale or retirement of property and equipment, the cost and related accumulated depreciation or amortization are eliminated from the respective accounts, and the resulting gain or loss is included in the determination of net income. Maintenance and repair costs are expensed as incurred.

g. Intangible Assets — Intangible assets are comprised of various licenses and patents that are recorded at cost. Amortization is computed using the straight-line method over the estimated useful life of the asset or the license period, whichever is shorter. Amortization periods range from 2 to 7 years.

h. Long-Lived Assets — The Company assesses the recoverability of long-lived assets at the entity level, whenever adverse events or changes in circumstances or business climate indicate that an impairment may have occurred. If the future cash flows (undiscounted and without interest) expected to result from the use of the related assets are less than the carrying value of such assets, an impairment has incurred and a loss is recognized to reduce the carrying value of the long-lived assets to fair value, which is determined by discounting estimated future cash flows. The Company has not recognized an impairment loss in any of the periods presented.

i. Revenue Recognition — Revenue subject to time-based contracts is recognized ratably over the duration of the contract. Deferred revenue represents the portion of revenue that has not been recognized related to time-based contracts. For contracts based on certain performance or delivery criteria, revenue is recognized in the month performance is delivered to the customer.

j. Advertising — Advertising costs are expensed as incurred. Advertising expense was \$31,423,213, \$14,136,270, and \$1,426,452, during the years ended December 31, 2000, 1999, and 1998, respectively.

k. Income Taxes — Until June 1, 1998, the Company had elected, under Section 1362(a) of the Internal Revenue Code, to be treated as an S-corporation for income tax purposes. As such, the Company was not liable for federal income taxes and any taxable income of the Company was included in the tax returns of the Company's shareholders. Income taxes are accounted for using an asset and liability approach, which requires the recognition of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the Company's financial statements or tax returns. The measurement of current and deferred tax liabilities and assets are based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

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

m. Capitalized Software Costs — The Company accounts for software development costs in accordance with the American Institute of Certified Public Accountants Statement of Position 98-1 ("SOP 98-1"), "Accounting for the Cost of Computer Software Developed or Obtained for Internal Use," which requires capitalization of certain costs including the cost of outside consultants. These costs are amortized using the straight-line method over three years, beginning when individual modules are placed into service. The Company recognized \$496,530 and \$111,659 in amortization expense for the years ended December 31, 2000 and 1999, respectively. No software development costs were capitalized in the year ended December 31, 2000. In the year ended December 31, 1999, the Company capitalized \$1.4 million dollars of software development costs.

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies (continued)

n. Capitalized Web Site Development Costs — Effective July 1, 2000, the Company applied the standards of EITF No. 00-2 (see Note 1s), which requires capitalization of certain Web site development costs. The Company capitalized costs of \$2,667,633 related to Web site development in the year ended December 31, 2000, and recorded \$47,851 of amortization expense.

o. Stock-Based Compensation — Financial Accounting Standards Board (“FASB”) Statement of Accounting Standards (SFAS) No. 123, “Accounting for Stock-Based Compensation,” encourages but does not require companies to record compensation cost for stock-based compensation at fair value. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees,” and its related Interpretations. Accordingly, compensation cost for stock options is measured as the excess, if any, of the fair market value of a share of the Company’s stock at the date of the grant over the amount that must be paid to acquire the stock. Total compensation expense recognized in connection with nonemployee stock option grants was \$16,312 during the year ended December 31, 1998. Due to the vesting terms of nonemployee options, no future compensation expense will be recognized in connection with these grants. No compensation expense has been recorded in connection with stock option grants in 1999. See Note 8h for a discussion of common stock compensation related to the departure of the former president of the Company.

On April 6, 2000, the Company granted an option to purchase up to \$500,000 of our common stock at the per share public offering price established in the Company’s initial public offering. This option was granted for consulting services related to intellectual property licensed by the Company. The options were valued at \$101,694 using the Black-Scholes option pricing model. The options expired unexercised during 2000.

p. Basic and Diluted Net Loss Per Share — The Company computes net loss per share in accordance with the provisions of SFAS No. 128, “Earnings per Share” (“SFAS No. 128”) and SEC Staff Accounting Bulletin No. 98 (“SAB No. 98”). Under the provisions of SFAS No. 128 and SAB No. 98, basic and diluted net loss per share applicable to common shareholders is computed by dividing the net loss applicable to common shareholders for the period by the weighted average number of common shares outstanding for the period.

The calculation of diluted net loss per share excludes shares of common stock issuable upon the conversion of unsecured convertible subordinated notes (see Note 5b), exercise of employee stock options and warrants (see Note 8g), and the conversion of preferred stock (see Note 8a), as the effect of such exercises would be anti-dilutive. Refer to Note 9—Earnings Per Share for the reconciliation of the numerator and denominator of the basic and diluted EPS calculation.

q. Comprehensive Earnings — The Company reports comprehensive earnings in accordance with SFAS No. 130, “Reporting Comprehensive Income,” which establishes standards for the reporting and display of comprehensive earnings and its components in general-purpose financial statements. There were no components of other comprehensive income during any of the periods presented.

r. Segment Information — SFAS No. 131, “Disclosures About Segments of an Enterprise and Related Information,” requires that management identify operating segments based on the way that management desegregates the entity for making internal operating decisions. The Company currently operates under the definition of one segment.

s. Recent Pronouncements — In June 1998, the FASB issued SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities.” This statement establishes accounting and reporting standards for derivative instruments and hedging activities and requires recognition of all derivatives as assets or liabilities in the statement of financial position and measurement of those instruments at fair value. The statement as amended is effective for the Company commencing January 1, 2001. As the Company does not have any derivative instruments or hedging activities, SFAS No. 133 is not expected to have a material effect on its financial results.

In May 2000, the Emerging Issues Task Force (“EITF”) released Issue No. 00-2, “Accounting for Web Site Development Costs.” EITF Issue No. 00-2 establishes standards for determining the capitalization or expensing of incurred costs relating to the development of Internet Web sites based upon the respective stage of development. The Issue is effective for fiscal quarters beginning after June 30, 2000 (including costs incurred for projects in process at the beginning of the quarter of adoption). The Company applied this guidance effective July 1, 2000 (see Note 1n).

Notes to Financial Statements
 Note 8. Shareholders' Equity (continued)

The following information relates to stock options whose exercise price exceeds the fair value of the underlying stock on the date of grant:

	Year Ended December 31,					
	2000		1999		1998	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of period	—	\$ —	287,500	\$2.29	—	\$ —
Granted	—	—	—	—	287,500	2.29
Exercised	—	—	(287,500)	2.29	—	—
Forfeited/expired	—	—	—	—	—	—
Outstanding at end of period	—	\$ —	—	\$ —	<u>287,500</u>	\$2.29
Weighted average fair value of options granted during the period		\$ —		\$ —		\$0.12

The following information relates to stock options whose exercise price is less than the fair value of the underlying stock on the date of grant:

	Year Ended December 31,					
	2000		1999		1998	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of period	—	\$ —	230,000	\$2.10	—	\$ —
Granted	—	—	—	—	230,000	2.10
Exercised	—	—	(230,000)	2.10	—	—
Forfeited/expired	—	—	—	—	—	—
Outstanding at end of period	—	\$ —	—	\$ —	<u>230,000</u>	\$2.10
Weighted average fair value of options granted during the period		\$ —		\$ —		\$0.29

The following table summarizes information about fixed stock options outstanding at December 31, 2000:

Exercise Price Range	December 31, 2000				
	Options	Average Life (in years)	Outstanding Weighted Average Exercise Price	Options	Exercisable Weighted Average Exercise Price
\$0.28 – \$ 1.75	416,187	6.68	\$0.53	324,737	\$0.28
\$2.17 – \$ 3.69	2,316,030	7.86	2.26	762,680	2.17
\$4.14 – \$ 6.25	294,200	9.06	4.83	58,190	4.37
\$7.00 – \$11.00	<u>1,702,615</u>	9.10	8.70	<u>5,750</u>	7.91
Totals	<u>4,729,032</u>	8.28	\$4.59	<u>1,151,357</u>	1.78

The Company adopted the disclosure requirements of Statement of Financial Accounting Standards No. 123 ("SFAS No. 123"), "Accounting for Stock Based Compensation," upon establishing the Employee Plan and the Non-Employee Plan. As permitted by SFAS No. 123, the Company continues to apply the accounting provisions of APB Opinion Number 25, "Accounting for Stock

Issued to Employees," with regard to the measurement of compensation cost for options granted. The Company recognized \$4.0 million, \$0 and \$16,312 of compensation expense during 2000, 1999 and 1998, in conjunction with grants made under its fixed stock option plans. Had expense been recognized using the fair value method described in SFAS No. 123, the Company would have

Notes to Financial Statements
 Note 8. Shareholders' Equity (continued)

reported the following results of operations using the Black-Scholes option pricing model:

	Year Ended December 31,		
	2000	1999	1998
Pro forma net loss applicable to common shareholders	\$(41,953,818)	\$(17,608,725)	\$ (6,005,992)
Deemed dividend	(19,867,723)	—	—
Net loss available to common shareholder	\$(61,821,541)	\$(17,608,725)	\$ (6,005,992)
Weighted average shares outstanding	36,313,759	29,804,681	21,547,177
Pro forma net loss per basic and diluted share	\$ (1.70)	\$ (0.59)	\$ (0.28)

These costs may not be representative of the total effects on pro forma reported income for future years. Factors that may also impact disclosures in future years include the attribution of the awards to the service period, the vesting period of stock options, timing of additional grants of stock option awards and number of shares granted for future awards.

The assumptions used for valuations of option grants calculated in accordance with SFAS 123 are as follows:

	2000	1999	1998
Annualized dividend yield	0.00%	0.00%	0.00%
Risk-free rate of return	6.28%	5.60%	5.50%
Expected option term (in years)	5.00	6.66	3.95
Expected volatility	74.80%	0.00%	0.00%

h. Common Stock Compensation — On December 30, 1999, the Company entered into a termination and consulting agreement with its former President. In conjunction with the termination and consulting agreement, the Company agreed, effective January 6, 2000, to extend the expiration date of the former president's options to purchase an aggregate of 661,250 shares of the Company's common stock at a price of \$2.17 per share until the first anniversary of the termination of the consulting agreement. The extension of the stock option agreements resulted in a remeasurement of the compensation cost associated with the stock options. Accordingly, a total noncash compensation charge of \$3,960,000 was recognized on a straight-line basis during 2000.

Note 9. Earnings Per Share

SFAS 128 requires companies to provide a reconciliation of the numerator and denominator of the basic and diluted EPS computations. The calculation below provides net loss, weighted average common shares outstanding and the resultant net loss per share for both basic and diluted EPS for the years ended December 31, 2000, 1999 and 1998.

	Year Ended December 31,		
	2000	1999	1998
<i>Numerator</i>			
Net loss	\$(39,239,948)	\$(16,868,379)	\$ (5,741,260)
Deemed dividend representing the beneficial conversion feature of preferred stock	(19,867,723)	—	—
Loss available to common shareholders	\$(59,107,671)	\$(16,868,379)	\$ (5,741,260)
<i>Denominator</i>			
Weighted average common shares	36,313,759	29,804,681	21,547,177
<i>Earnings Per Share</i>			
Basic and diluted	\$ (1.63)	\$ (0.57)	\$ (0.27)

Note 10. 401(k) Plan

On February 11, 1997, the Company adopted a 401(k) plan for employees. All employees who meet certain age requirements are eligible to participate. Matching contributions are made at the discretion of the Company. The Company made no matching contributions during 2000, 1999, or 1998.

Note 11. Subsequent Events

Commencing in the fourth quarter of 2000, and continuing in the first quarter of 2001, the Company has implemented a cost reduction program which includes, among other cost savings measures, reductions in marketing expenditures, cost of acquiring members, and reductions in the overall number of employees. In March 2001, the Company has commenced a private offering of its convertible debentures and warrants to increase its liquidity.