CARESCIENCE INC
Form 10-Q
November 09, 2001

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2001

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: 0-30859

CARESCIENCE, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

PENNSYLVANIA	23-2703715
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)

3600 MARKET STREET
PHILADELPHIA, PA 19104
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)
(ZIP CODE)

(215) 387-9401
(REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE)

(FORMER NAME, FORMER ADDRESS AND FORMER FISCAL YEAR, IF CHANGED SINCE LAST REPORT)

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 [ ]

The number of shares of the registrant's Common Stock outstanding, as of November 9, 2001 was 13,280,016.

CARESCIENCE INC.

FORM 10-Q

SEPTEMBER 30, 2001

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

CARESCIENCE, INC.
CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	DECEMBER 31, 2000	SEPTEM 200
ASSETS		
Current assets:		
Cash and cash equivalents	$ 26,702,096	$ 16,4
Short-term investments	3,001,770	6,0
Interest receivable	174,034	
Accounts receivable, net of allowance for doubtful accounts of $48,794 and $63,854, respectively	865,075	1,3
Prepaid expenses and other	240,345	7
Total current assets	30,983,320	24,6
Property and equipment:		
Computer equipment	4,611,573	4,9
Office equipment	482,385	4
Furniture and fixtures	397,629	3
	5,491,587	5,8
Less--Accumulated depreciation and amortization	(2,562,342)	(3,6
Net property and equipment	2,929,245	2,2
Goodwill and other intangibles, net	--	1,3
Total assets	$ 33,912,565	$ 28,1
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current portion of capital lease obligations and note payable	$ 250,685	$ 3
Accounts payable	1,090,613	2
Accrued expenses	1,141,662	1,0
Deferred revenues	3,035,511	4,2
Total current liabilities	5,518,471	5,9
Capital lease obligations	428,602	2
Shareholders' equity:		
Common stock, no par value, 16,000,000 shares authorized, 14,206,851 and 14,720,016 shares issued and 12,766,851 and 13,280,016 outstanding	59,612,380	60,2
Additional paid-in capital	5,590,620	5,3
Deferred compensation	(4,010,828)	(2,8
Accumulated other comprehensive income	1,770	
Accumulated deficit	(32,328,450)	(39,5
Subscription receivables	--	(4
Treasury stock, at cost, 1,440,000 shares	(900,000)	(9
Total shareholders' equity	27,965,492	21,9
Total liabilities and shareholders' equity	$ 33,912,565	$ 28,1

The accompanying notes are an integral part of these statements.

CARESCIENCE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	FOR THE THREE MONTHS ENDED SEPTEMBER 30,		FOR THE NINE ENDED SEPTEM
	2000	2001	2000
Revenues	$ 2,207,402	$ 3,508,661	$ 5,758,384
Cost of revenues (excludes stock-based compensation of $171,088 and $512,278 for the three and nine months ended September 30, 2000, respectively, and $163,209 and $489,831 for three and nine months ended September 30, 2001, respectively)	1,275,550	1,614,151	3,450,016
Gross profit	931,852	1,894,510	2,308,368
Operating expenses:			
Research and development (excludes stock-based compensation of $23,922 and $70,779 for the three and nine months ended September 30, 2000, respectively, and $9,772 and $29,316 for three and nine months ended September 30, 2001, respectively)	1,329,069	840,567	2,734,740
Selling, general and administrative (excludes stock-based compensation of $146,742 and $439,387 for the three and nine months ended September 30, 2000, respectively, and $142,707 and $428,249 for three and nine months ended September 30, 2001, respectively)	2,192,210	2,420,400	5,533,485
Stock-based compensation	341,752	315,688	1,022,444
Total operating expenses	3,863,031	3,576,655	9,290,669
Operating loss	(2,931,179)	(1,682,145)	(6,982,301)
Interest income	(561,695)	(247,675)	(627,982)
Interest expense	23,839	23,497	68,302
Net loss	(2,393,323)	(1,457,967)	(6,422,621)
Accretion of redemption premium on preferred stock	--	--	253,731

Preference distribution on preferred stock	--	--	5,716,784
Net loss applicable to common shareholders	$ (2,393,323)	$ (1,457,967)	$(12,393,136)
Net loss per common share:			
Basic and diluted	$ (0.19)	$ (0.11)	$ (1.88)
Weighted average shares outstanding:			
Basic and diluted	12,756,851	13,277,384	6,602,066

The accompanying notes are an integral part of these statements.

CARESCIENCE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,	
	2000	2001
Cash flows from operating activities:		
Net loss	$ (6,422,621)	$ (7,231,791)
Adjustments to reconcile net loss to net cash used inoperating activities--		
Depreciation and amortization	577,132	1,034,710
Loss on disposal	--	158,000
Provision for bad debts	12,000	14,475
Stock-based compensation	1,022,444	947,396
Changes in assets and liabilities--		
(Increase) decrease in--		
Interest receivable	(395,084)	119,559
Accounts receivable	(53,634)	(270,076)
Prepaid expenses and other	(150,277)	(495,571)
Increase (decrease) in--		
Accounts payable and accrued expenses	953,952	(1,057,447)
Deferred revenues	82,923	805,068
Net cash used in operating activities	(4,373,165)	(5,975,677)
Cash flows used in investing activities:		
Proceeds from the redemption of short-term investments	--	5,000,115
Purchases of short-term investments	(20,500,129)	(8,000,000)
Purchase of acquisition, net	--	(882,367)
Purchases of property and equipment, net	(1,761,450)	(302,155)

Net cash used in investing activities	(22,261,579)	(4,184,407)
Cash flows provided by (used in) financing activities:		
Proceeds from note payable	--	237,751
Payments on capital lease obligations and note payable	(278,040)	(343,805)
Cost related to the issuance of Common stock	(1,285,047)	--
Payments of dividends of Series C, D, & E Preferred Stock	(1,516,785)	--
Redemption of Series F Preferred Stock	(4,935,367)	--
Proceeds from the issuance of common stock and exercise of common stock options	44,640,000	4,883
Net cash provided by (used in) financing activities	36,624,761	(101,171)
Net increase (decrease) in cash and cash equivalents	9,990,017	(10,261,255)
Cash and cash equivalents, beginning of period	3,381,600	26,702,096
Cash and cash equivalents, end of period	$ 13,371,617	$ 16,440,841

The accompanying notes are an integral part of these statements.

CARESCIENCE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated balance sheet as of September 30, 2001, the statements of operations for the three and nine months ended September 30, 2000 and 2001 and the statements of cash flows for the nine months ended September 30, 2000 and 2001 have been prepared by the Company without audit. In the opinion of management, all adjustments, consisting of normal and recurring adjustments, necessary to present fairly the financial position, results of operations and cash flows at September 30, 2001 and for all periods presented have been made.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. It is suggested that these financial statements be read in conjunction with the financial statements and notes thereto included in the Annual Report on Form 10-K as filed with the Securities and Exchange Commission. The results of operations for the three and nine months ended September 30, 2001 are not necessarily indicative of the operating results for the full year.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of CareScience, Inc. and its subsidiary. All significant intercompany transactions and balances have been eliminated.

New Accounting Prounouncements

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations". SFAS No. 141 eliminates the use of the pooling-of-interests method of accounting for business combinations and establishes the purchase method of accounting as the only acceptable method on all business combinations initiated after June 30, 2001.

In June 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets." This statement modifies existing generally accepted accounting principles related to the amortization and impairment of goodwill and other intangible assets. Upon adoption of the new standard, goodwill, including goodwill associated with equity method investments, will no longer be amortized. For the nine months ended September 30, 2001, goodwill amortization was $129,070. In addition, goodwill, other than goodwill associated with equity method investments, must be assessed at least annually for impairment using a fair-value based approach. The provisions of this statement are required to be adopted as of the beginning of the first fiscal year after December 15, 2001. Impairment losses that arise due to the initial application of this statement are to be reported as a cumulative effect of change in accounting principle. The Company has not completed an analysis of the impact of implementing the provisions of this statement.

Cash and Cash Equivalents and Short-term Investments

The Company invests excess cash in highly liquid investment-grade marketable securities including corporate commercial paper and U.S. government agency bonds. For financial reporting purposes, the Company considers all highly liquid investment instruments purchased with an original maturity of three months or less to be cash equivalents. All investment instruments with maturities greater than three months are available for use in current operations and accordingly are classified as current assets.

All investments are considered available-for-sale and accordingly, unrealized gains and losses are included in a separate component of shareholders' equity.

As of September 30, 2001 cash and cash equivalents and short-term investments at cost and fair market value consisted of the following:

	SEPTEMBER 30, 2001		
	ORIGINAL COST	GROSS UNREALIZED GAINS	FAIR MARKET VALUE
Cash and cash equivalents	$16,440,841	$ --	$16,440,841
Short-term investments	6,000,000	41,900	6,041,900
	$22,440,841	$ 41,900	$22,482,741

At September 30, 2001, short-term investments consisted of a $2 million debt instrument maturing July 25, 2002 and two $2 million debt instruments each maturing August 28, 2002.

Supplemental Cash Flow Information

The Company paid interest of $68,302 and $66,215 for the nine months ended September 30, 2000 and 2001, respectively.

The Company financed $252,401 and $0 of property and equipment purchases with capital leases for the nine months ended September 30, 2000 and 2001, respectively.

Major Customers

The Company's operations are conducted in one business segment and sales are primarily made to health care payors and providers. The Company had one customer for each of the nine month periods ended September 30, 2000 and 2001, which accounted for 20% and 13% of total revenues, respectively. The Company also had two customers for each of the three month periods ended September 30, 2000 and 2001, which accounted for 31% and 22% of total revenues, respectively.

The Company had two customers at September 30, 2001, which accounted for 31% of total accounts receivable.

(2) NET LOSS PER SHARE

Net loss per share is calculated utilizing the principles of SFAS No. 128, "Earnings per Share" ("SFAS No. 128"). Basic Earnings per Share ("EPS") excludes potentially dilutive securities and is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS is computed assuming the conversion or exercise of all dilutive securities such as preferred stock, options and warrants.

Under SFAS No. 128, the Company's granting of certain stock options, warrants and convertible preferred stock resulted in potential dilution of basic EPS. The number of incremental shares from the assumed exercise of stock options and warrants is calculated applying the treasury stock method. Stock options, warrants and Preferred stock convertible into common shares were excluded from the calculations as they were anti-dilutive due to the net loss.

(3) COMMITMENTS AND CONTINGENCIES

CareScience and certain of its officers are defendants in several purported shareholder class action lawsuits described below for alleged violations of federal securities laws. Although we cannot predict the ultimate outcome of the case or estimate the range of any potential loss that may be

incurred in the litigation, we believe the lawsuits are frivolous and without merit, strenuously deny all allegations of wrongdoing asserted by plaintiffs, and believe we have meritorious defenses to plaintiffs' claims. We intend to vigorously defend the lawsuits.

CareScience and certain of its officers are defendants in a purported class action litigation pending in the United States District Court for the

Eastern District of Pennsylvania. These actions are the result of several complaints filed with the Court beginning on October 17, 2001. We are currently seeking to consolidate these actions. These complaints purport to bring claims on behalf of all persons who allegedly purchased our common stock between June 29, 2000 and November 1, 2000, for alleged violations of the federal securities laws, including Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 by issuing a materially false and misleading Prospectus and Registration Statement with respect to the initial public offering of our common stock. Specifically, the complaints allege, among other things, that our Prospectus and Registration Statement misrepresented and omitted to disclose material facts concerning two of our prospective products. The actions seek compensatory and other damages, and costs and expenses associated with litigation.

(4) SHAREHOLDERS'EQUITY

Subscriptions Receivable

On June 15, 2001 the Company issued 259,259 shares of its Common stock to seven of its officers and three of its directors in a private sale at a price of $1.62 per share which is equal to the closing price of its Common stock on the Nasdaq National Market on that date. Concurrent with this sale, full recourse notes bearing interest at a rate of 4.11% compounded semi-annually, were issued to these officers and directors. The total amount of such notes issued was $420,000.

Equity Compensation Plans

The Company's 1995 Equity Compensation Plan (the "Plan") permits the granting of incentive stock options, nonqualified stock options, stock appreciation rights and restricted stock. The Company has authorized the issuance of up to 2,565,038 shares of Common stock to satisfy grants under the Plan. At September 30, 2001, there were 480,786 shares reserved under the Plan available for grant. A committee of the Board of Directors (the "Committee") administers the Plan and determines the terms of the grants.

In December 1998, the Company adopted the 1998 Time Accelerated Restricted Stock Option Plan (the "Accelerated Plan"). The Accelerated Plan provides for the granting of non-qualified stock options to officers, senior management and employee directors of the Company. The aggregate number of shares of Common stock the Company may issue under the Accelerated Plan is 483,594 shares. At September 30, 2001 there were no shares reserved under the Accelerated Plan available for grant.

The Company accounts for all plans under APB Opinion No. 25, under which compensation expense is recognized based on the amount by which the fair value of the underlying common stock exceeds the exercise price of the stock options on the measurement date. For financial reporting purposes, the Company has determined that the deemed fair market value on the measurement date for certain stock options was in excess of the exercise price. This amount has been recorded as deferred compensation and is being amortized over the vesting period of the applicable options, which range between four and seven years. The Company recorded deferred compensation of $120,683 and $0 during the year ended December 31, 2000 and the nine months ended September 30, 2001, respectively and reversed $154,902 and $233,643 of deferred compensation in connection with forfeited common stock options during the year ended December 31, 2000 and the nine months ended September 30, 2001, respectively. The Company recognized $341,752 and $1,022,444 of compensation expense related to options for the three and nine months ended September 30, 2000, respectively and $315,688 and $947,396 of compensation expense related to options for the three and nine months ended September 30, 2001, respectively.

The following table summarizes the option activity for both plans:

	SHARES AVAILABLE FOR GRANT	OPTIONS OUTSTANDIN NUMBER OF SHARES	EXERCISE PRICE PER SHARE	AGGREGA PRICE
Balance, December 31, 1997.............	362,800	251,200	$0.25- 1.25	$ 271,
Authorized..........................	1,134,632	--	--	
Granted.............................	(472,635)	472,635	1.25- 2.60	895,
Forfeited/Canceled..................	12,800	(12,800)	0.25- 1.25	(10,
Balance, December 31, 1998.............	1,037,597	711,035	0.25- 2.60	1,155,
Authorized..........................	--	--	--	
Granted.............................	(1,108,150)	1,108,150	1.25- 2.59	2,814,
Forfeited/Canceled..................	216,413	(216,413)	0.25- 2.59	(291,
Balance, December 31, 1999.............	145,860	1,602,772	0.25- 2.60	3,678,
Authorized..........................	800,000	--	--	
Granted.............................	(817,663)	817,663	0.78-12.00	6,782,
Forfeited/Canceled..................	573,298	(573,298)	1.25-12.00	(4,926,
Excercised..........................	--	(10,000)	0.25	2,
Balance, December 31, 2000.............	701,495	1,837,137	0.25-12.00	5,537,
Authorized (unaudited)..............	500,000	--	--	
Granted (unaudited).................	(880,036)	880,036	0.38- 2.81	1,563,
Forfeited/canceled (unaudited).......	159,327	(159,327)	0.78- 6.63	(442,
Excercised (unaudited)..............	--	(3,906)	1.25	(4,
Balance, September 30, 2001(unaudited)	480,786	2,553,940	$0.25-12.00	$6,652,

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

This report includes a number of forward-looking statements that reflect our current views with respect to future events and financial performance. We use words such as anticipates, believes, expects, future, and intends, and similar expressions to identify forward-looking statements. For these statements we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. There are important factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements, including:

- the difficulty in evaluating our business because we operate in a new industry and our operating history is limited;

- we have a history of losses and expect our losses to continue;

- the proprietary technology we own or license may be subjected to infringement claims or disagreements with the licensor which could be costly to resolve;

- we depend on exclusive licenses with the University of Pennsylvania and California Health Care Foundation for important parts of our technology, and the loss of either of these licenses would impair our ability to develop our business;

- we could be liable for information retrieved from our Web sites and incur significant costs from resulting claims;

- we may experience system failures which could interrupt our service and damage our customer relationships;

- the health care industry may not accept our solutions or buy our products which would adversely affect our financial results;

- because our revenues are dependent on a limited number of product lines, the failure of any one of these product lines would significantly decrease our revenues;

- termination of one or more of our significant contracts would cause a significant decline in our revenue;

- failure to manage our growth would adversely affect our operations;

- we face intense competition and may be unable to compete successfully which would adversely affect our financial results;

- the loss of any of our key personnel could adversely affect our operations;

- our failure to develop strategic relationships could adversely affect our ability to develop new products;

- our failure to use new technologies effectively or to adapt emerging industry standards would adversely affect our ability to compete;

- our failure to adapt our technology to our customers' needs or to handle high levels of customer activity would adversely affect our ability to increase revenue;

- failure of our service providers could interrupt our business and damage our customer relationships;

- we may need to obtain additional capital and failure to do so may limit our growth;

- health information is subject to potential government regulation and legal uncertainties and changes may require us to alter our business;

- changes in the health care industry could adversely affect our operations;

- our business will suffer if commercial users do not accept Internet solutions;

- our industry is evolving and we may not adapt successfully.

Overview

CareScience, Inc. is a provider of online care management services. Our mission is to transform the quality and efficiency of care delivery by providing innovative clinical information technology to the health care industry. We market our services to hospitals, health systems and pharmaceutical and biotechnology manufacturers, and support more than 150 customers in 40 states and in Europe.

We work with health care providers to manage clinical processes surrounding the point of care so that fundamental reductions in errors and operating cost can be achieved. Our online service offerings collect, share, store and analyze clinical data generated by more than 100 widely used health information systems. Our services allow customers to apply this data to the management of care, including quality monitoring, practice improvement, credentialing, profiling, error tracking, case management and clinical guidelines. We provide consulting services to healthcare providers that support strategic planning and clinical operations, with a special emphasis on mentoring physicians and other clinical leaders in operational and executive roles.

For the pharmaceutical and biotechnology industry, we provide tools and services that shorten the drug development cycle and improve development yield. Our offerings include a suite of Internet-based data analysis and workflow management tools, consulting services, customized research and strategic development support. These tools and services are aimed at the specialized drug development needs of pharmaceutical industry clinicians, product managers, market strategists, health economists and outcomes researchers.

We have pioneered and commercialized numerous clinical information technologies. We have developed one of the nation's first online quality measurement and management tools, one of the first clinically based outcome risk assessment algorithms, one of the first health care application service providers, and, most recently, the first peer-to-peer clinical data sharing technology. We have developed these tools in collaboration with leading public organizations, including the Wharton School of Business at the University of Pennsylvania, the National Library of Medicine, Los Alamos National Laboratory and The California HealthCare Foundation.

CareScience was incorporated in 1992 with the purpose of commercializing intellectual property that was developed at the University of Pennsylvania School of Medicine and The Wharton School of Business. In 1993, we exclusively licensed the intellectual property underlying our core technology in a 30-year agreement with the University of Pennsylvania. In 1996, we launched our first Internet-based commercial offering based on this proprietary technology under our Care Management System-TM- (formerly called CaduCIS) service line. In 1999, we launched our Care Data Exchange-TM-, and Technology Assessment Tools-TM-, as well as our Lifecycle Decision System-TM- service line, which is aimed at the pharmaceutical and biotechnology industries. To date, we have signed more than 50 contracts covering more than 150 hospitals, health systems and pharmaceutical companies.

We generate revenues from subscriptions to our Internet-based proprietary technology applications and hosting of customer data, as well as from training, implementation and consulting services. We sell our services individually or as an integrated suite of services. Our contracts are fixed price based on estimates of certain variables, such as the number of a hospital's patient admissions or outpatient visits.

Our subscription and development agreements typically cover an initial three-to five-year period with provisions for automatic renewals. We recognize training and implementation fees, as well as subscriptions and related hosting revenues, on a pro-rata basis over the life of the contract. We recognize consulting fees on a percentage-of-completion basis or as the program or service is delivered.

Our contracts generally provide for payment in advance of services rendered. Therefore, we record these payments as deferred revenues and recognize these payments when earned in accordance with our revenue recognition policy. Our deferred revenue balances were $3.0 million and $4.3 million at December 31, 2000 and September 30, 2001, respectively.

We have incurred substantial research and development costs since inception and have also invested in our corporate infrastructure to support our long-term growth strategy. We expect that our operating expenses will continue to exceed our gross profit, and as a result, we expect to continue to incur quarterly net losses for the foreseeable future.

On June 28, 2000 we completed an initial public offering of 4,000,000 shares of Common stock at a price of $12.00 per share. We received aggregate net cash proceeds of approximately $43.2 million from the initial public offering on July 5, 2000.

RESULTS OF OPERATIONS

THREE MONTHS ENDED SEPTEMBER 30, 2001 AND SEPTEMBER 30, 2000

REVENUES

Total revenues increased 59% to $3.5 million for the three months ended September 30, 2001 from $2.2 million for the three months ended September 30, 2000. The increase was primarily related to revenues generated for services provided under newly signed customer contracts.

Unrecognized revenues related to customer contracts as of September 30, 2001 totaled $18.0 million.

COST OF REVENUES

Cost of revenues include customer product and service-related costs including personnel and facility costs, depreciation and maintenance. Cost of revenues for the three months ended September 30, 2001 was $1.6 million (excluding stock-based compensation of $163,000), an increase of $339,000 or 27%, compared to $1.3 million (excluding stock-based compensation of $171,000) for the three months ended September 30, 2000. The increase was primarily a result of additional costs necessary to service new customers.

GROSS PROFIT

Our gross profit margin increased from 42% for the three months ended September 30, 2000, to 54% for the three months ended September 30, 2001. The increase in gross profit margin is primarily due to increased revenues spread over a partially fixed cost base.

RESEARCH AND DEVELOPMENT

Research and development costs include technology and product development costs. Research and development costs for the three months ended September 30, 2001 were $841,000 (excluding stock-based compensation of $10,000), a decrease of $489,000 or approximately 37%, compared to $1.3 million (excluding stock-based compensation of $24,000) for the three months ended September 30, 2000. This decrease is primarily due to the allocation of resources to the other areas as well as a reduction of emphasis on the development of new products.

As a percentage of revenue, research and development costs were 24% for the three months ended September 30, 2001 as compared to 60% for the three months ended September 30, 2000.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative expenses include costs associated with our sales, marketing, finance, human resource and administrative functions. Selling, general and administrative expenses for the three months ended September 30, 2001 were $2.4 million (excluding stock-based compensation of $143,000), an increase of $228,000, or 10% compared to $2.2 million (excluding stock-based compensation of $147,000) for the three months ended September 30, 2000. The increase was primarily related to hiring of additional sales and management personnel and marketing expenditures to increase and support customer growth.

As a percentage of revenues, selling, general, and administrative expenses were 69% for the three months periods ended September 30, 2001 as compared to 99% for the three months ended September 30, 2000.

STOCK-BASED COMPENSATION

We granted certain stock options to our officers and employees with exercise prices deemed to be below the fair market value of the underlying stock. The remaining cumulative difference between the fair value of the underlying stock at the date the options were granted and the exercise price of the granted options was $2.8 million at September 30, 2001. We expect to amortize this amount over the four to seven year vesting periods of the granted options. Accordingly, our results from operations will include stock-based compensation expense at least through 2006. We recognized $342,000 and $316,000 of this expense during the three months ended September 30, 2000 and 2001, respectively.

INTEREST INCOME AND EXPENSE

Net interest income for the three months ended September 30, 2001 was $224,000, a decrease of $314,000 compared to $538,000 for the three months ended September 30, 2000. The decrease is primarily due to lower investable cash balances as funds from the initial public offering have been used to fund operations.

NINE MONTHS ENDED SEPTEMBER 30, 2001 AND SEPTEMBER 30, 2000

REVENUES

Total revenues increased 56% to $9.0 million for the nine months ended September 30, 2001 from $5.8 million for the nine months ended September 30, 2000. The increase was primarily related to revenues generated for services provided under newly signed customer contracts.

COST OF REVENUES

Cost of revenues include customer product and service-related costs including personnel and facility costs, depreciation and maintenance. Cost of revenues for the nine months ended September 30, 2001 was $4.5 million (excluding stock-based compensation of $490,000), an increase of $1.0 million

or 30%, compared to $3.5 million (excluding stock-based compensation of $512,000) for the nine months ended September 30, 2000. The increase was primarily a result of additional costs necessary to service new customers.

GROSS PROFIT

Our gross profit margin increased from 40% for the nine months ended September 30, 2000, to 50% for the nine months ended September 30, 2001. The increase in gross profit margin is primarily due to increased revenues spread over a partially fixed cost base.

RESEARCH AND DEVELOPMENT

Research and development costs include technology and product development costs. Research and development costs for the nine months ended September 30, 2001 were $3.2 million (excluding stock-based compensation of $29,000), an increase of $433,000 or approximately 16%, compared to $2.7 million (excluding stock-based compensation of $71,000) for the nine months ended September 30, 2000. This increase is primarily due to expenditures made related to new product development.

As a percentage of revenue, research and development costs were 35% of revenue for the nine months ended September 30, 2001 as compared to 47% for the nine months ended September 30, 2000.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative expenses include costs associated with our sales, marketing, finance, human resource and administrative functions. Selling, general and administrative expenses for the nine months ended September 30, 2001 were $8.5 million (excluding stock-based compensation of $428,000); an increase of $2.9 million, or 53% compared to $5.5 million (excluding stock based compensation of $439,000) for the nine months ended September 30, 2000. The increase was primarily related to hiring of additional sales and management personnel and marketing expenditures to increase and support customer growth.

As a percentage of revenues, selling, general, and administrative expenses were 94% for the nine months ended September 30, 2001 as compared to 96% for the nine months ended September 30, 2000.

STOCK-BASED COMPENSATION

We granted certain stock options to our officers and employees with exercise prices deemed to be below the fair market value of the underlying stock. The remaining cumulative difference between the fair value of the underlying stock at the date the options were granted and the exercise price of the granted options was $2.8 million at September 30, 2001. We expect to amortize this amount over the four to seven year vesting periods of the granted options. Accordingly, our results from operations will include stock-based compensation expense at least through 2006. We recognized $1.0 million and $947,000 of this expense during the nine months ended September 30, 2000 and September 30, 2001, respectively.

INTEREST INCOME AND EXPENSE

Net interest income for the nine months ended September 30, 2001 was $823,000, an increase of $263,000 compared to $560,000 for the nine months ended September 30, 2000. The increase is primarily due to higher investable cash balances as a result of the initial public offering.

LIQUIDITY AND CAPITAL RESOURCES - SEPTEMBER 30, 2001

Since inception, we have financed our operations and funded our capital expenditures through the private sale of equity securities, supplemented by debt and equipment leases. As of September 30, 2001, we had $22.5 million in cash and short term investments and working capital of $18.7 million.

Net cash used in operating activities was $6.0 million for the nine months ended September 30, 2001 and $4.4 million for the nine months ended September 30, 2000. For those periods, net cash used in operating activities was primarily to fund losses from operations partially offset by changes in current assets and liabilities.

Net cash used in investing activities was $4.2 million for the nine months ended September 30, 2001 and consisted of purchases of short-term investments (net of proceeds), funding of an acquisition and purchases of property and equipment. For the nine months ended September 30, 2000 net cash used in investing activities was $22.3 million and consisted of purchases of short-term investments and property and equipment.

Net cash used in financing activities was $101,000 for the nine months ended September 30, 2001. Financing activities for this period consisted primarily of payments on capital lease obligations and proceeds from issuance of a note payable. Net cash provided by financing activities was $36.6 million for the nine months ended September 30, 2000 and consisted primarily of the proceeds of the initial public offering net of the payment of dividends and redemption of preferred stock.

As we execute our strategy, we expect significant increases in our operating expenses to fund development of current and new divisions and product lines. Presently, we anticipate that our existing capital resources will meet our operating and investing needs through the end of 2002. After that time, additional funding may not be available on acceptable terms or at all. If we require additional capital resources to grow our business, execute our operating plans or acquire complementary businesses at any time in the future, we may seek to sell additional equity or debt securities or secure additional lines of credit, which may result in ownership dilution to our shareholders.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Most of our cash equivalents and capital lease obligations are at fixed interest rates and therefore the fair market value of these instruments is affected by changes in market interest rates. As of September 30, 2001 all of our cash equivalents matured within 90 days and we had the ability to immediately liquidate our investments. Therefore, we believe that we are exposed to immaterial levels of market risk.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

CareScience and certain of its officers are defendants in several purported shareholder class action lawsuits described below for alleged violations of federal securities laws. Although we cannot predict the ultimate outcome of the case or estimate the range of any potential loss that may be incurred in the litigation, we believe the lawsuits are frivolous and without merit, strenuously deny all allegations of wrongdoing asserted by plaintiffs, and believe we have meritorious defenses to plaintiffs' claims. We intend to vigorously defend the lawsuits.

CareScience and certain of its officers are defendants in a purported class action litigation pending in the United States District Court for the Eastern District of Pennsylvania. These actions are the result of several complaints filed with the Court beginning on October 17, 2001. We are currently seeking to consolidate these actions. These complaints purport to bring claims on behalf of all persons who allegedly purchased our common stock between June 29, 2000 and November 1, 2000, for alleged violations of the federal securities laws, including Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 by issuing a materially false and misleading Prospectus and Registration Statement with respect to the initial public offering of our common stock. Specifically, the complaints allege, among other things, that our Prospectus and Registration Statement misrepresented and omitted to disclose material facts concerning two of our prospective products. The actions seek compensatory and other damages, and costs and expenses associated with litigation.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

USE OF PROCEEDS

On June 28, 2000 the Securities and Exchange Commission declared effective our Registration Statement on Form S-1 (File number 333-32376), relating to the initial public offering of our Common

Stock, no par value per share. The net offering proceeds to us after total expenses were $43.2 million. As of September 30, 2001, we have used approximately $21.3 million of the net proceeds from our initial public offering of which approximately $11.4 million was used for working capital and other general corporate purposes, approximately $6.5 million was used for dividends on and the redemption of preferred stock, approximately $2.3 million was used for the purchase of property plant and equipment and $1.1 million was used for the acquisition of Strategic Outcomes Services, Inc.

None of the net proceeds from the offering were used to pay, directly or indirectly, directors, officers, persons owning ten percent or more of the Company's equity securities, or affiliates of the Company.

ITEM 5. OTHER INFORMATION

On October 30, 2001, our board of directors approved the amendment and restatement of the Company's Amended and Restated 1995 Equity Compensation Plan in order to amend the change of control provisions of that plan. The amendment and restatement of the plan became effective upon approval by our board of directors. The amended and restated plan is attached as an exhibit to this Form 10-Q and is incorporated by reference herein.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

See Exhibit Index.

(b) Reports on Form 8-K

None

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

CARESCIENCE, INC.

Date: November 9, 2001

By: /s/ RONALD A. PAULUS
Ronald A. Paulus, President

Date: November 9, 2001

By: /s/ STEVEN BELL
Steven Bell, Chief Financial Officer and Treasurer

EXHIBIT INDEX

EXHIBIT NO.	DESCRIPTION
10.1	Amended and Restated 1995 Equity Compensation Plan