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Comprehensive loss
(782)
Net transfers from TSC
7,777

Balance, December 31, 1998
(587) 47,888

Net income
4,058
Foreign currency translation
(260) (260)

Comprehensive income
3,798
Net transfers from TSC
21,929
Issuance of common stock

Issuance of compensatory stock options
(963)

Balance, December 31, 1999
(847) (963) 73,615

Net (loss) income
2,171 (424)
Foreign currency translation
(1,123) (1,123)

Comprehensive loss
(1,547)
Net transfers and capital contribution from TSC
24,802
Spin-off from Technology Solutions Company

Issuance of common stock pursuant to stock-based awards
8,552
Issuance of common stock to venture capital firms
34,914
Issuance of compensatory stock options
(524)
Issuance of restricted common stock pursuant to cancellation of certain stock options
(3,737)
Amortization of unearned compensation
520 520

Balance, December 30, 2000
$2,171 $(1,970) $(4,704) $140,856

The accompanying Notes to Consolidated Financial Statements

are an integral part of this financial information.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

eLoyalty Corporation
(In Thousands, Except Per Share Data)

Note One Description of Business

eLoyalty is a global management consulting and systems integration organization focused exclusively on building customer loyalty. eLoyalty has a broad range of Customer Relationship Management (CRM) related services including business strategy, technical architecture, selecting, implementing and integrating appropriate CRM software applications and providing ongoing support for multi-vendor systems.

eLoyalty was spun off from Technology Solutions Company (TSC) into a separate, publicly traded company on February 15, 2000 (the spin-off). The spin-off, which was approved by the TSC Board of Directors on February 9, 2000, was accomplished by distributing to TSC stockholders, as a dividend, all of the outstanding common stock of eLoyalty owned by TSC. In the spin-off, TSC stockholders received one share of eLoyalty common stock, par value $0.01 per share, for every one share of TSC common stock they owned of record as of February 9, 2000.

Note Two Summary of Significant Accounting Policies

Basis of Presentation The financial statements for periods subsequent to the spin-off reflect eLoyalty s results of operations and financial position as it operates as a separate, publicly traded company. The consolidated financial statements for periods prior to the spin-off reflect eLoyalty s results of operations and financial position as it operated within TSC, and have been prepared using the historical basis in the assets, liabilities and results of operations.

The consolidated statements of operations for the periods prior to February 15, 2000 reflect all of the related costs of doing business including an allocation of certain general corporate expenses of TSC not directly related to eLoyalty s operations, including legal, information systems, finance, insurance, human resources, benefits administration, stockholders services and corporate management services. These costs were allocated to eLoyalty primarily on a proportional cost allocation method based on revenues and headcount. Management believes these allocations were made on a reasonable basis.

The financial information for periods prior to February 15, 2000 may not necessarily reflect what the financial position and results of operations of eLoyalty would have been had eLoyalty operated as a separate, stand-alone publicly traded entity during such periods.

Certain reclassifications have been made to the 1999 and 1998 statements of operations to conform to the 2000 presentation.

Change in Fiscal Year-End In connection with implementing new business systems and processes in December 2000, eLoyalty changed from a calendar year-end to a fiscal year ending with the Saturday closest to the end of December. The fiscal year-end for 2000 is December 30. Also, on November 22, 1998, TSC s Board of Directors voted to change the fiscal year of TSC from a fiscal year ending on May 31 to a calendar year ending on December 31 in each year. The seven month period of June 1, 1998 through December 31, 1998 preceded the start of the new December 31 fiscal year.

Consolidation The consolidated financial statements include the accounts of eLoyalty and all of its subsidiaries. All significant intercompany transactions have been eliminated.

Revenue Recognition eLoyalty derives substantially all of its revenues from professional services. eLoyalty provides professional services primarily on a time and materials basis. Although eLoyalty occasionally performs projects on a fixed fee basis, the total portion of revenues derived from fixed fee engagements is not significant. eLoyalty recognizes revenues on the percentage of completion method as services are performed, based on hourly billing rates. Percentage of completion estimates are based on the ratio of costs incurred to total estimated costs. From time to time, eLoyalty uses subcontractors to supplement its resources in client engagements. Revenues generated through subcontractors are recognized as the service is performed,

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and the related subcontractor costs are included in project personnel costs as incurred. Out-of-pocket expenses (travel, lodging, etc.) charged on client engagements are presented net of amounts billed to clients as general and administrative expense in the statements of operations. Losses on engagements, if any, are recognized when determined. eLoyalty also derives revenues from in-house developed software. Software license fee revenues are recognized when persuasive evidence of an arrangement exists, delivery has occurred, the license fee is fixed and determinable and the collection of the fee is probable. Fees from licenses sold together with consulting services are generally recognized upon delivery, provided that the above criteria have been met and payment of the license fees is not dependent upon the performance of the consulting services. In those instances when it is determined that the payment of the license fee is dependent upon the performance of consulting services, both the license and consulting fees are recognized under the percentage of completion method of contract accounting. Revenues from post-contract Loyalty Support are recognized ratably over the term of the maintenance contract on a straight-line basis. Revenues from purpose-built hosted solutions and **e-Profile** are recognized ratably over the contract term.

Project Personnel Costs eLoyalty expenses the cost of project personnel as incurred. Project personnel costs consist primarily of salaries, incentive compensation and employee benefits for eLoyalty personnel available for client assignments, and fees paid to subcontractors for work performed on client projects.

Cash and Cash Equivalents eLoyalty considers all highly liquid investments readily convertible into cash (with original maturities of three months or less) to be cash equivalents. These short-term investments are carried at cost plus accrued interest, which approximates market.

Marketable Securities eLoyalty s marketable securities consist of investments related to eLoyalty s executive deferred compensation plan (see Note Nine) and are classified as trading securities, with unrealized gains and losses included in eLoyalty s statements of operations. Realized gains or losses are determined based on the specific identification method. eLoyalty recognized a net loss of $89 for the year ended December 30, 2000 and net gains of $730, $167 and $823 for the year ended December 31, 1999, the seven month period ended December 31, 1998 and the fiscal year ended May 31, 1998, respectively. Since trading securities relate to eLoyalty s executive deferred compensation plan, a corresponding adjustment is included in the statements of operations to recognize eLoyalty s increased/decreased liability for the deferred compensation plan.

Equipment and Leasehold Improvements Computers, software, furniture and equipment are carried at cost and depreciated on a straight-line basis over their estimated useful lives. Leasehold improvements are amortized over the lesser of the useful life or the lease term. Useful lives generally are five years or less. Maintenance and repair costs are expensed as incurred. The cost and related accumulated depreciation of assets sold or disposed of are moved from the account and resulting gain or loss is included in the statements of operations. The carrying value of equipment and leasehold improvements is periodically reviewed to assess recoverability based on future undiscounted cash flows.

eLoyalty accounts for software developed for internal use in accordance with Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. As such, costs incurred that relate to the planning and post-implementation phases of development are expensed. Costs incurred in the development phase are capitalized and amortized over the asset s estimated useful life, generally three to five years.

Goodwill Goodwill is amortized on a straight-line basis, generally over a five-year period. Accumulated amortization of goodwill as of December 30, 2000 and December 31, 1999 was $16,477 and $11,518, respectively. The carrying value of goodwill is periodically reviewed to assess recoverability based on future undiscounted cash flows.

Research and Development Costs Research and development costs are expensed as incurred. Research and development expenses relate primarily to the dedicated research and development facility maintained by eLoyalty, and consist primarily of salaries, incentive compensation and employee benefits costs for dedicated personnel, occupancy costs, staff recruiting costs, administrative costs, travel expenses and depreciation.

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Software Development Costs eLoyalty capitalizes software development costs once technological feasibility is established and prior to general release. Amortization is computed as the greater of the amount computed using the (a) ratio of current revenues to the total current and anticipated future revenues or (b) the straight-line method over the estimated economic life of the product. There are no capitalized software development costs included on eLoyalty s balance sheets as of December 30, 2000 and December 31, 1999. Amortization expense associated with software development costs was $447 and $354 for the seven month period ended December 31, 1998 and the fiscal year ended May 31, 1998, respectively. There was no amortization expense of software development costs during the year ended December 30, 2000 or December 31, 1999.

Stockholders Equity Stockholders equity includes common stock issued, retained earnings, accumulated other comprehensive income (loss) related to foreign currency translation and unearned compensation related to stock-based compensation. Net advances from TSC represent transfers to eLoyalty primarily for operations and working capital requirements, offset by cash collected by TSC for the periods prior to the spin-off. In connection with the spin-off, net advances from TSC were recorded as common stock and additional paid-in capital (see Note Three). Following the spin-off, eLoyalty no longer received operational funding from TSC and no longer participated in the TSC cash management program.

Earnings (Loss) Per Common Share eLoyalty calculates earnings (loss) per share in accordance with SFAS No. 128. Basic earnings per share have been computed by dividing the net earnings for each period presented by the weighted average shares outstanding. Diluted earnings per share has been computed by dividing the net earnings by the weighted average shares outstanding plus the dilutive effect of common stock equivalents using the treasury stock method. In periods in which there was a loss, the dilutive effect of common stock equivalents was not included in the dilutive earnings per share calculation as they were antidilutive.

Foreign Currency Translation The functional currencies for eLoyalty s foreign subsidiaries are their local currencies. All assets and liabilities of foreign subsidiaries are translated to U.S. dollars at end of period exchange rates. The resulting translation adjustments are recorded as a component of stockholders equity. Income and expense items are translated at average exchange rates prevailing during the period. Gains and losses from foreign currency transactions of these subsidiaries are included in the statements of operations.

Fair Value of Financial Instruments The carrying values of current assets and liabilities and long-term receivables approximated their fair values as of December 30, 2000 and December 31, 1999.

Concentration of Credit Risk eLoyalty had one client, Agilent Technologies, Inc., accounting for 15% of revenues for the year ended December 30, 2000. No client accounted for 10% or more of revenues during the year ended December 31, 1999, the seven month period ended December 31, 1998 or the year ended May 31, 1998. No client accounted for 10% or more of accounts receivables as of December 30, 2000 or December 31, 1999.

Stock-Based Compensation eLoyalty accounts for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Compensation costs for employee stock options is measured as the excess, if any, of the fair value of common stock at the date of grant over the amount an employee must pay to acquire the stock, providing that all other requirements for fixed plan accounting are satisfied. In the event stock options are granted at a price lower than the fair value on the date of grant, the difference is recorded as unearned compensation. Cancelled and reissued stock options are accounted for under variable plan accounting with the related unearned compensation subject to adjustment in future periods based on the fluctuations of the fair value of the common stock. Unearned compensation is amortized over the vesting period of the stock options. The unearned compensation recorded at December 30, 2000 and December 31, 1999 relates solely to eLoyalty stock-based awards.

Income Taxes eLoyalty uses an asset and liability approach, as required under SFAS No. 109, to financial accounting and reporting for income taxes. Deferred income taxes are provided when tax laws and financial accounting standards differ with respect to the amount of income for a year and the basis of assets

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and liabilities and for tax loss carryforwards. eLoyalty does not provide U.S. deferred income taxes on earnings of foreign subsidiaries which are expected to be indefinitely reinvested. Prior to the spin-off, eLoyalty s results have been included in TSC s consolidated federal and state income tax returns. The income tax provision for such periods is calculated, and deferred tax assets and liabilities are recorded, as if eLoyalty had operated as an independent entity.

New Accounting Standards On June 15, 1998, the Financial Accounting Standards Board (FASB) issued SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 133, as amended, is effective for fiscal years beginning after June 15, 2000 (2001 for eLoyalty). SFAS No. 133 requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and, if it is, the type of hedge transaction. eLoyalty anticipates that the adoption of SFAS No. 133 will not have a significant effect on eLoyalty s results of operations, cash flows or financial position.

Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements (SAB 101), provides guidance in applying generally accepted accounting principles to selected revenue recognition issues in financial statements. On June 26, 2000, the SEC issued SAB 101B, an amendment to SAB 101, which delayed the implementation of SAB 101 until no later than the fourth fiscal quarter of fiscal years beginning after December 15, 1999. The implementation of SAB 101 had no material effect on eLoyalty.

Note Three eLoyalty Spin-off From Technology Solutions Company

eLoyalty was spun off from TSC into a separate, publicly traded company on February 15, 2000. In connection with the spin-off, TSC s net advances to eLoyalty were recorded as common stock and additional paid-in capital. The net assets distributed to eLoyalty were as follows:

(In 000 s)	February 15, 2000
Cash	$30,794
Receivables, net	50,056
Other current assets	23,603
Goodwill	11,342
Other long-term assets	7,379
Accounts payable	1,238
Other current liabilities	26,784

Note Four Related Party Transactions

Pursuant to the spin-off, on February 15, 2000, eLoyalty entered into contractual arrangements with TSC whereby TSC provided eLoyalty with certain administrative support through 2000. The total charges from TSC for the years ended December 30, 2000 and December 31, 1999, the seven month period ended December 31, 1998 and the fiscal year ended May 31, 1998 were $5,036, $14,173, $8,429 and $11,643 respectively.

eLoyalty periodically provides employee loans as part of employment agreements. These loans have interest rates ranging from 4.5% to 7.5%. The loans are generally forgiven over one to three years at various rates, depending on the value of the loan and the terms of the employment agreement, based on continued employment with eLoyalty. The unforgiven loan balances and related accrued interest are due and payable in full if an employee terminates employment before the end of the loan term. The total value of outstanding employee loans, including certain loans to officers, was $3.4 million and $2.1 million, respectively, as of December 30, 2000 and December 31, 1999.

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Note Five Receivables

Receivables consist of the following:

	As of December	
	2000	1999
Amounts billed to clients	$62,501	$39,552
Unbilled revenues	14,990	6,588

	77,491	46,140
Receivable allowances	(1,605)	(2,084)
Receivables	$75,886	$44,056

Amounts billed to clients represent professional fees and reimbursable project-related expenses. Unbilled revenues represent professional fees, project-related expenses, materials and subcontractor costs performed in advance of billings in accordance with contract terms. A substantial amount of unbilled revenues at the end of any reporting period is billed in the month following the reporting period. Amounts billed to clients are unsecured and primarily due within 30 days.

Note Six Equipment and Leasehold Improvements

Equipment and leasehold improvements consist of the following:

	As of December	
	2000	**1999**
Computers and software	$15,840	$3,636
Furniture and equipment	4,750	1,006
Leasehold improvements	3,338	729
	23,928	5,371
Accumulated depreciation and amortization	(5,144)	(3,087)
Equipment and leasehold improvements	$18,784	$2,284

Depreciation expense was $2,057, $1,502, $421 and $308 for the years ended December 30, 2000 and December 31, 1999, the seven month period ended December 31, 1998 and the fiscal year ended May 31, 1998, respectively.

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Note Seven Income Taxes

The income tax (benefit) provision consists of the following:

	For the Year Ended December 30, 2000	For the Year Ended December 31, 1999	For the Seven Month Period from June 1 to December 31, 1998	For the Year Ended May 31, 1998
Current:				
Federal	$6,950	$4,546	$(1,929)	$115
State	859	1,059	(275)	16
Foreign	(712)	1,876	(830)	(227)
Total current	7,097	7,481	(3,034)	(96)
Deferred:				
Federal	(1,923)	(2,008)	1,941	1,357
State	204	(478)	277	194
Foreign	(5,802)	(956)	1,214	567

Total deferred	(7,521)	(3,442)	3,432	2,118
Income tax (benefit) provision	$(424)	$4,039	$398	$2,022

Total income tax (benefit) provision differed from the amount computed by applying the federal statutory income tax rate due to the following:

	For the Year Ended December 30, 2000	For the Year Ended December 31, 1999	For the Seven Month Period From June 1 To December 31, 1998	For the Year Ended May 31, 1998
Federal tax provision (benefit), at statutory rate	$(297)	$2,834	$(50)	$1,475
State tax provision (benefit), net of Federal benefit	539	405	(6)	211
Effect of foreign tax rate differences	(1,205)	406	303	34
Nondeductible expenses	208	134	61	96
Nondeductible goodwill	235	279	170	172
Other	96	(19)	(80)	34
Income tax (benefit) provision	$(424)	$4,039	$398	$2,022

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Deferred tax assets and liabilities were comprised of the following:

	As of December	
	2000	1999
Deferred tax assets:		
Deferred compensation and bonuses	$3,753	$2,870
Equity losses of unconsolidated investee	341	341
Receivable allowances	448	918
Other accruals	2,061	936
Net operating loss carryforwards	10,798	4,996
Depreciation and amortization	2,680	2,387
Total deferred tax assets	20,081	12,448
Deferred tax liabilities:		
Prepaid expenses	(1,116)	(1,004)
Total deferred tax liabilities	(1,116)	(1,004)

Net deferred tax asset	$18,965	$11,444

Net operating loss carryforwards relate primarily to eLoyalty s UK operations and have an indefinite carryforward period. Pursuant to the Tax Sharing and Disaffiliation Agreement between TSC and eLoyalty, TSC will generally be liable to eLoyalty for any income tax benefits realized by TSC related to the exercise of eLoyalty stock options by TSC employees (see Note Twelve). With respect to the realizability of these tax benefits, if any, eLoyalty is dependent on TSC s ability to realize the benefits, and accordingly, eLoyalty does not recognize these benefits until realized by TSC.

Income (loss) before income taxes consisted of the following:

	For the Year Ended December 30, 2000	For the Year Ended December 31, 1999	For the Seven Month Period from June 1 to December 31, 1998	For the Year Ended May 31, 1998
United States	$18,602	$7,447	$(164)	$3,781
Foreign	(19,450)	650	19	454
Total	$(848)	$8,097	$(145)	$4,235

Note Eight Line of Credit

eLoyalty entered into a business loan agreement with Bank of America, N.A. (the Bank) effective as of December 30, 2000, providing for an unsecured revolving line of credit in a maximum principal amount of $10 million through December 30, 2001 (the Facility). The Facility in effect extended and superseded eLoyalty s prior March 2000 revolving credit agreement with the Bank, which had been guaranteed by TSC and expired on December 30, 2000. eLoyalty s only borrowings under the prior line of credit related to letters of credit required for operational commitments and aggregated $0.7 million at year-end 2000; this aggregate outstanding letter of credit amount was carried forward as outstanding under the Facility. Loans under the Facility bear interest at the Bank s prime rate or, at eLoyalty s election, an alternate rate of IBOR (an offshore U.S. dollar interbank interest rate) plus 0.75%. Under the Facility, eLoyalty agreed to pay a commitment fee of 0.125% of the unused portion of the $10 million commitment and certain other loan fees and expenses.

The Facility requires eLoyalty to comply with various affirmative and negative covenants, including ones relating to the maintenance of consolidated tangible net worth of at least $70 million, limitations on other liabilities, liens and investments and limitations on aggregate annual lease payments. In addition, eLoyalty agreed to maintain unencumbered liquid assets with an aggregate market value of from 100% to 150% (depending on the nature of such assets and their location) of the total commitment. Accordingly, eLoyalty

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will be required to maintain at least $10 million in liquid asset coverage throughout 2001 to be in compliance with these covenants and to have credit availability under the Facility.

Note Nine Executive Deferred Compensation Plan

All eLoyalty executives (defined for this purpose as Vice Presidents and above) are eligible to participate in the eLoyalty Executive Deferred Compensation Plan (the EDCP). The EDCP is a nonqualified deferred compensation plan that permits participants to elect to defer receipt of a portion of their compensation. Deferred contributions and investment earnings are payable to participants upon various specified events, including retirement, disability or termination. The accompanying consolidated balance sheets include the deferred compensation liability, including investment earnings thereon, owed to participants. The accompanying consolidated balance sheets also include the investments, classified as trading securities, purchased by eLoyalty with the deferred funds. These investments remain assets of eLoyalty and are available to the general creditors of eLoyalty in the event of eLoyalty s insolvency. Prior to the spin-off from TSC, eLoyalty executives participated in the TSC non-qualified executive deferred compensation plan.

Note Ten Employee Benefit Plans

eLoyalty 401(k) Savings Plan eLoyalty employees are eligible to participate in the eLoyalty Corporation 401(k) Savings Plan (the 401(k) Plan) on the first day of the month coinciding with or following their date of hire. The 401(k) Plan allows employees to contribute up to 15% of their annual compensation, subject to Internal Revenue Service statutory limits. Company contributions are made annually to the 401(k) Plan at the discretion of the Board of Directors. Prior to the spin-off from TSC, eLoyalty employees participated in the TSC 401(k) Plan. eLoyalty recognized expenses related to these 401(k) plans of $1,697 and $1,131 for the years ended December 30, 2000 and December 31, 1999, $487 for the seven month period ended December 31, 1998 and $470 in the fiscal year ended May 31, 1998.

eLoyalty Employee Stock Purchase Plan eLoyalty employees are eligible to participate in the eLoyalty employee stock purchase plan (the Stock Purchase Plan) after meeting certain minimum eligibility service requirements. The Stock Purchase Plan qualifies under section 423 of the Internal Revenue Code (IRC) and is administered by the Compensation Committee of the Board of Directors. The Stock Purchase Plan permits eligible employees to purchase an aggregate of 500,000 shares of eLoyalty s common stock. Shares are purchased by the plan for the benefit of the participants at the end of each three month purchase period. The Stock Purchase Plan purchased 250,281 shares of eLoyalty common stock for the year ended December 30, 2000.

Note Eleven Capital Stock

eLoyalty was spun off from TSC into a separate, publicly traded company on February 15, 2000. In connection with establishing eLoyalty as a separate entity, 100,000,000 shares of common stock, $0.01 par value, were authorized, of which 43,929,029 common stock shares were issued. eLoyalty also has authorized 10,000,000 shares of preferred stock, $0.01 par value, of which none has been issued.

Pursuant to the spin-off, eLoyalty also received $8.4 million from the sale of 2.5 million shares of common stock to Technology Crossover Ventures (TCV) and Sutter Hill Ventures. On May 26, 2000, eLoyalty also closed its common stock purchase agreement with TCV entities and issued 2 million shares of common stock at $13.50 per share, the closing market price on April 18, 2000, the signing date of the initial letter of intent, for proceeds of $26.5 million, net of issuance costs.

On March 17, 2000, the Board of Directors adopted a Stockholder Rights Plan (the Rights Plan). The Rights Plan is intended to assure fair and equal treatment for all of eLoyalty s stockholders in the event of a hostile takeover attempt.

Under the terms of the Rights Plan, each share of eLoyalty s common stock has associated with it one Right. Each Right entitles the registered holder to purchase from eLoyalty one one-hundredth of a share of Series A junior participating preferred stock, without par value, at an exercise price of $160 (subject to

adjustment). The Rights become exercisable under certain circumstances: 10 days after the first public announcement that any person has acquired 15% or more of eLoyalty s common stock or the announcement that any person has commenced a tender offer for 15% or more of eLoyalty s common stock.

In general, eLoyalty may redeem the Rights in whole, but not in part, at a price of $0.01 per Right at any time until 10 days after any person has acquired 15% or more of eLoyalty s common stock. The Rights will expire on March 17, 2010, unless earlier redeemed by eLoyalty or exchanged for other shares of eLoyalty s common stock.

Under specified conditions, each Right will entitle the holder to purchase eLoyalty s common stock at the exercise price (or if eLoyalty is acquired in a merger or other business combination, common stock of the acquiror) having a current market value of two times the exercise price. The terms of the Rights may be amended by eLoyalty s Board of Directors.

Note Twelve Stock Incentive Plans

eLoyalty maintains two stock incentive plans: the eLoyalty Corporation 1999 Stock Incentive Plan (the 1999 Plan) and the eLoyalty Corporation 2000 Stock Incentive Plan (the 2000 Plan).

Under the 1999 Plan, awards of stock options, stock appreciation rights, bonus and restricted stock and performance share may be granted to directors, officers, employees, consultants, independent contractors and agents of eLoyalty and its subsidiaries. Stock option awards may be in the form of incentive or non-statutory options, provided that incentive stock options may only be granted to officers and employees of eLoyalty. All awards made under the 1999 Plan to date have been in the form of non-statutory stock options or restricted stock. An aggregate of 5,340,000 shares of eLoyalty common stock was initially reserved for issuance under the 1999 Plan for all awards other than those issued in connection with the spin-off as discussed below. On the first day of each fiscal year, beginning in 2000, the aggregate number of shares available for issuance under the 1999 Plan is automatically increased by an amount equal to 5% of the total number of shares of common stock that are outstanding as of the time of the increase. In addition, 7,387,561 shares were reserved for issuance under the 1999 Plan in connection with the spin-off in substitution of previously granted options to purchase shares of TSC common stock. These substitute options are not subject to the limit on shares reserved set forth above.

On May 12, 2000, the Board of Directors approved the eLoyalty Corporation 2000 Stock Incentive Plan. Under the 2000 Plan, non-statutory stock option awards may be granted to officers, employees and certain consultants and independent contractors of eLoyalty and its subsidiaries. An aggregate of 2,800,000 shares of eLoyalty common stock has been reserved for issuance under the 2000 Plan.

If options or shares awarded under the 1999 Plan and the 2000 Plan are not issued due to forfeiture or other reason, then those options or shares will again become available for issuance under the plans. As of December 30, 2000, there were a total of 1,419,742 shares available for future grants under the 1999 and 2000 Plans.

Stock options granted under the 1999 Plan and 2000 Plan are made at the discretion of the Compensation Committee of eLoyalty s Board of Directors or another duly constituted Committee of the Board to the extent authorized by such plans and the Board (the Compensation Committee). Most employees are eligible to receive a grant of non-statutory stock options periodically with the number of shares generally determined by the employee s position grade, performance level and the size of the award pool as determined by the Compensation Committee. In addition, full-time employees normally receive a grant of non-statutory stock options upon hire. Stock options are generally granted with an exercise price per share equal to the fair market value of a share of eLoyalty common stock on the date of grant and a maximum term of 10 years. Although the Compensation Committee has the authority to set other terms, the options generally become exercisable over a period of four years. The initial vesting may occur after a one or two-year period, with the balance of the shares vesting in equal monthly installments over the remainder of the four-year period, or the entire award may vest in equal monthly increments over the four-year period.

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The 1999 Plan was amended in December 2000 to increase the number of option shares automatically awarded to non-employee directors. The 1999 Plan, as amended, provides that each non-employee director will receive a non-statutory stock option to purchase 50,000 shares of eLoyalty common stock when he or she commences service as a director. In addition, on the day following the date of each annual shareholders meeting, each non-employee director will receive a non-statutory stock option to purchase 12,000 shares of eLoyalty common stock. Stock options granted to non-employee directors have an exercise price per share equal to the fair market value of a share of eLoyalty common stock on the grant date and a maximum term of 10 years. Stock options granted to non-employee directors upon commencement of services vest ratably over a period of 48 months. Stock options granted to non-employee directors following an annual shareholders meeting vest ratably over a period of 12 months.

At the time of the spin-off, each outstanding option to purchase TSC common stock held by a person who was an employee or director of eLoyalty immediately after the spin-off (and who was not also a director of TSC) was converted into a substitute option to purchase eLoyalty common stock. Furthermore, each outstanding TSC option granted before June 22, 1999 to a person who was an employee or director of TSC after the spin-off, or who was neither an employee or director of eLoyalty or TSC after the spin-off, was converted into both an adjusted TSC option and a substitute eLoyalty option. The conversion of the options was done in a manner such that (1) the aggregate intrinsic value of the options immediately before and after the exchange were the same, (2) the ratio of the exercise price per option to the market value per option was not reduced, and (3) the vesting provisions and option period of the replacement options are the same as the original vesting terms and option period. The substitute option will take into account all employment with both TSC and eLoyalty for purposes of determining when the option becomes exercisable and when it terminates. All other terms of the substitute option are the same as the terms of the TSC option to which it relates. Of the 7,387,561 substitute option shares issued in connection with the spin-off, 3,557,823 were issued to persons who were employees or directors of eLoyalty immediately after the spin-off.

Under the 1999 Stock Incentive Plan, eLoyalty granted 293,125 shares of restricted stock to certain executives during the year ending December 30, 2000. During the restricted period, the holders of such shares have the same rights as stockholders of eLoyalty, except that the shares may not be sold, assigned, pledged or otherwise encumbered. Restrictions on such shares lapse ratably over a period of 60 months. As of December 30, 2000, a total of 268,670 shares continued to be subject to restrictions.

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Option activity was as follows for the years ending December 31, 1999 and December 30, 2000:

	Option Shares	Weighted-Average Exercise Price	Options Exercisable
Outstanding as of December 31, 1998			
Granted	5,447,250	$3.88	
Exercised			
Forfeited	(107,250)	$3.50	
Outstanding as of December 31, 1999	5,340,000	$3.89	
Granted	5,066,914	$20.91	
Granted in connection with the spin-off(1)			

7,387,561 $6.85
Exercised
(913,287) $6.24
Forfeited
(1,908,386) $18.65

Outstanding as of December 30, 2000
14,972,802 $9.09 5,941,429

(1) Includes options issued in connection with the spin-off in substitution of previously granted TSC options.

The following table summarizes the status of stock options outstanding and exercisable as of December 30, 2000 by range of exercise price:

	Options Outstanding			**Options Exercisable**	
Range of Number Exercise Prices	**Number Outstanding**	**Weighted-Average Remaining Contractual Life (In Years)**	**Weighted-Average Exercise Price Per Share**	**Number Exercisable**	**Exercise Price Per Share**
$ 0.27- $4.99	6,772,844	8.7	$3.04	2,335,432	$2.15
$ 5.00- $9.99	3,437,144	7.7	$7.88	2,342,282	$7.96
$10.00-$14.99	3,306,278	9.0	$13.51	760,184	$13.31
$15.00-$24.99	541,252	8.8	$18.96	326,824	$18.37
$25.00-$36.63	915,284	9.1	$36.60	176,707	$36.60
Total	14,972,802	8.6	$9.09	5,941,429	$7.79

eLoyalty has elected to disclose the pro forma effects of SFAS No. 123, Accounting for Stock-Based Compensation, (SFAS 123) and, as permitted under SFAS 123, applies Accounting Principles Board Opinion No. 25 (APB 25) and related interpretations in accounting for its plans.

Under APB 25, compensation costs for employee stock options is measured as the excess, if any, of the fair value of eLoyalty stock at the date of grant over the option exercise price, providing all other requirements for fixed plan accounting are satisfied. Some option shares with exercise prices below fair value were issued by eLoyalty in 1999 and 2000, thus resulting in eLoyalty recording related compensation expense. During 2000 eLoyalty cancelled and reissued options for 112,000 shares at a lower exercise price. The cancellation and reissuance of these shares was necessary to meet commitments made to newly hired employees. These replacement options are accounted for under variable plan accounting and the related compensation will be subject to adjustment in the future periods based on the fluctuation of the fair value of a share of eLoyalty s common stock. No compensation expense was recognized for these reissued options during 2000 based on the fair value of eLoyalty s common stock during 2000. In addition, options for 586,250 shares were cancelled and replaced through the issuance of the restricted common stock discussed above. Under APB No. 25, the fair value of restricted shares at the date of grant is amortized to expense ratably over the restriction period. eLoyalty recorded compensation expense related to stock-based awards of approximately $520,000 for the year ended December 30, 2000.

eLoyalty is required under SFAS 123 to disclose pro forma information regarding option grants made to its directors, officers and employees based on specified valuation techniques that produce estimated compensation charges. The fair value of eLoyalty options, including substitute options issued in connection with the spin-off, were estimated at grant date using the Black-Scholes option pricing model. The weighted

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average grant date fair value and the assumptions used in the Black-Scholes model to calculate such fair values are shown below:

Options	For the Year Ended December 30, 2000	For the Year Ended December 31, 1999	For the Seven Month Period Ended December 31, 1998	For the Year Ended May 31, 1998
Substitute TSC Options(1) Expected volatility		49.7%-54.2%	43.6%-49.8%	41.9%-44.1%

Risk-free interest rates
4.6%-6.3% 4.1%-5.6% 5.3%-6.5%
Expected lives
4.5 years 4.5 years 4.5 years
Dividends

Weighted average grant date fair value
$5.08 $8.15 $7.90
eLoyalty Options

Expected volatility

50% 50%
Risk-free interest rates
5.6%-6.8% 5.7%-6.3%
Expected lives
4.5 years 4.5 years
Dividends

Weighted average grant date fair value

Issued above market prices
$12.62
Issued at market prices
$ 5.31 $1.79
Issued below market prices
$ 8.54 $8.62

(1) eLoyalty stock options issued in connection with the spin-off in substitution of previously granted TSC options.

Had compensation costs for eLoyalty s stock option plans been determined using the fair value method under SFAS No. 123, eLoyalty s net (loss) income and earnings (loss) per share would have been reduced to the pro forma amounts indicated below:

	For the Year Ended December 30, 2000	For the Year Ended December 31, 1999	For the Seven Month Period Ended December 31, 1998	For the Year Ended May 31, 1998
Net (loss) income:				
As reported	$(424)	$4,058	$(543)	$2,213
Pro forma	$(12,381)	$1,219	$(2,574)	$(500)
Basic net (loss) income per share:				
As reported	$(0.01)	$0.10	$(0.01)	$0.05
Pro forma	$(0.26)	$0.03	$(0.06)	$(0.01)
Diluted net (loss) income per share:				
As reported	$(0.01)	$0.09	$(0.01)	$0.05
Pro forma	$(0.26)	$0.03	$(0.06)	$(0.01)

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Note Thirteen Earnings Per Share

The following table sets forth the computation of the shares used in the calculation of basic and diluted earnings per share:

For the Years Ended **For the Fiscal**

	December 2000	December 1999	For the Seven Month Period from June 1 to December 31, 1998	Year Ended May 31, 1998
Weighted average shares outstanding	48,231	41,400	41,400	41,400
Common stock equivalents(1)	5,491	2,800	NA(2)	5,400
Total weighted average shares and common stock equivalents	53,722	44,200	41,400	46,800

(1) In December 1999 eLoyalty issued 41.4 million shares to TSC. For periods prior to February 15, 2000 the weighted average shares outstanding is based on the 41.4 million shares.

(2) Common stock equivalent information was not previously calculated for this period when eLoyalty was part of TSC as they were antidilutive. Subsequent to the spin-off eLoyalty does not maintain the information to calculate common stock equivalents for this period.

Note Fourteen Segment Information

eLoyalty operates as a single reportable segment. The following is revenue and long-lived asset information by geographic area as of and for the years ended December 30, 2000 and December 31, 1999, the seven month period ended December 31, 1998 and the fiscal year ended May 31, 1998.

	United States	Canada	Europe and Australia	Total
For the Year Ended December 30, 2000				
Revenues	$176,012	$9,432	$26,159	$211,603
Identifiable Assets	$147,219	$6,616	$30,783	$184,618
For the Year Ended December 31, 1999				
Revenues	$113,504	$7,577	$24,922	$146,003

Identifiable Assets
$63,770 $3,874 $28,959 $96,603
For the Seven Month Period Ended December 31,1998

Revenues
$50,139 $3,729 $10,547 $64,415
Identifiable Assets
$42,715 $3,300 $17,889 $63,904
For the Year Ended May 31, 1998

Revenues
$61,882 $6,296 $16,310 $84,488
Identifiable Assets
$34,711 $3,008 $16,399 $54,118

Note Fifteen Leases

eLoyalty leases various office facilities under operating leases expiring at various dates through September 30, 2007. Additionally, eLoyalty leases various property and office equipment under operating leases expiring at various dates. Rental expense for all operating leases approximated $6,659, $1,436, $469 and $738 for the years ended December 30, 2000 and December 31, 1999, the seven month period ended

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December 31, 1998 and for the fiscal year ended May 31, 1998, respectively. Future minimum rental commitments under noncancelable operating leases with terms in excess of one year are as follows:

Year	Amount
2001	$6,804
2002	5,976
2003	3,570
2004	2,720
2005	1,622
Thereafter	756
	$21,448

Note Sixteen Quarterly Data (Unaudited)

(In thousands, except per share data)	1st	2nd	3rd	4th	Year
For the Year Ended December 2000					
Revenues	$46,179	$50,960	$56,818	$57,646	$211,603
Gross profit	$24,998	$26,052	$28,171	$28,179	$107,400
Net (loss) income					

	$156	$406	$348	$(1,334)(1)	$(424)
Basic net (loss) income per share	$0.00	$0.01	$0.01	$(0.03)	$(0.01)
Diluted net (loss) income per share	$0.00	$0.01	$0.01	$(0.03)	$(0.01)
Shares used to calculate basic net (loss) income per share (in millions)	44.3	47.9	49.7	49.8	48.2
Shares used to calculate diluted net (loss) income per share (in millions)	49.9	53.1	54.4	49.8	48.2
For the Year Ended December 1999					
Revenues	$31,491	$36,145	$40,016	$38,351	$146,003
Gross profit	$17,430	$19,191	$21,355	$19,544	$77,520
Net (loss) income	$727	$1,480	$1,879	$(28)	$4,058
Basic net (loss) income per share	$0.02	$0.04	$0.05	$(0.01)	$0.10
Diluted net (loss) income per share	$0.02	$0.03	$0.04	$(0.01)	$0.09
Shares used to calculate basic net (loss) income per share (in millions)	41.4	41.4	41.4	41.4	41.4
Shares used to calculate diluted net (loss) income per share (in millions)	42.4	42.4	44.6	41.4	44.2

(1) The fourth quarter of 2000 includes a $2.8 million incremental charge for uncollectable amounts due from clients.

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

The following Management s Discussion contains forward-looking statements that are based on current management expectations, forecasts and assumptions. These include, without limitation, statements containing the words believes, anticipates, estimates, expects, plans, intends, projects, future and similar expressions, references to plans, strategies, objectives and anticipated future performance, and other statements that are not strictly historical in nature. These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or implied by the forward-looking statements. Such risks, uncertainties and other factors that might cause such a difference include, without limitation, those noted under Factors That May Affect Future Results or Market Price of Stock included elsewhere in this Appendix. Readers should also carefully review the risk factors described in other documents eLoyalty files from time to time with the SEC, including eLoyalty s Annual Report on Form 10-K for the fiscal year ended December 30, 2000.

Readers are cautioned not to place undue reliance on forward-looking statements. They reflect opinions, assumptions and estimations only as of the date they are made, and eLoyalty undertakes no obligation to publicly update or revise any forward-looking statements in this report, whether as a result of new information, future events or circumstances, or otherwise.

Overview

eLoyalty is a global management consulting and systems integration organization focused exclusively on building customer loyalty. eLoyalty has a broad range of customer relationship management (CRM) related services including business strategy, technical architecture, selecting, implementing and integrating appropriate CRM software applications and providing ongoing support for multi-vendor systems.

eLoyalty was spun off from Technology Solutions Company (TSC) into a separate, publicly traded company on February 15, 2000 (the spin-off). Accordingly, the statements of operations for periods subsequent to the spin-off reflect eLoyalty s results as a stand-alone company. The statements of operations for periods prior to the spin-off are presented as if eLoyalty operated as a separate entity, and includes a cost allocation of certain TSC general corporate expenses that were not directly related to eLoyalty s operations. These costs were allocated proportionately to eLoyalty based on revenues and headcount.

Certain reclassifications have been made in the statements of operations for the years ended December 31, 1999 and 1998, the seven month periods ended December 31, 1998 and 1997, and the fiscal years ended May 31, 1998 and 1997 to conform to the 2000 presentation. In December 2000, eLoyalty changed its fiscal year from a calendar year to a fiscal year ending on the Saturday closest to the end of December. The fiscal year-end for 2000 is December 30. eLoyalty had previously changed its fiscal year-end from May 31 to December 31, effective December 31, 1998. For comparative purposes, eLoyalty has included discussions of the statements of operations data for the year ended December 31, 1998 and the seven month period ended December 31, 1997 which have been derived from unaudited financial statements. In the opinion of management, the unaudited financial statements for these periods reflect all adjustments, consisting of normal adjustments, necessary to present fairly eLoyalty s results of operations for the year ended December 31, 1998 and the seven month period ended December 31, 1997.

eLoyalty s revenues are generated primarily from professional services, which are billed principally on a time and materials basis. eLoyalty has, on occasion, contracted projects on a fixed fee basis. Revenues are recognized for time and material engagements as services are rendered.

Other growing revenue contributors include fees generated from Managed Services (including Loyalty Support services, purpose-built hosted solutions and e-Profile) and the licensing of proprietary software. These revenues comprised 6% and 3% of revenues in 2000 and 1999, respectively.

Our revenues from international operations represent revenues in Canada, Europe and Australia. International operations represented 17% and 22% of revenues for the years ended December 30, 2000 and December 31, 1999, respectively.

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We typically experience seasonal fluctuations in our revenues and earnings on a global basis in the fourth quarter because of the reduced number of billing days due to holidays. In addition, we have historically experienced decreases in revenues from our European operations in the third quarter because of extended vacation periods. Although those decreases in revenues have not been significant in the past, they may increase in the future, especially as we expand internationally.

eLoyalty s most significant operating cost is project personnel costs, which are comprised of labor costs including salaries, fringe benefits and incentive compensation of engageable consultants, as well as fees paid to subcontractors for work performed on an engagement.

Gross profit represents our revenues less project personnel costs. We anticipate that to the extent we have additional software and Managed Services revenues, our gross margins will increase. Gross profit margins, which have declined as a percent of revenue over the last three years, are negatively impacted by several factors, including the use of subcontractors and non-billable time incurred by project personnel.

Selling, general and administrative expenses consist primarily of salaries, incentive compensation and employee benefits for business development, marketing, managerial and administrative personnel, plus provisions for doubtful receivables. Other overhead expenses consist of employee costs for training, travel expenses, laptop computer leases and other non-billable expenses not directly related to projects or research and development. This would also include expenses relating to administrative and technical support services provided by TSC, which continued to be provided after the spin-off in 2000 as part of a shared services agreement.

Research and development expenses consist primarily of salaries, incentive compensation and employee benefits for dedicated personnel, staff recruiting costs, administrative costs, travel expenses and depreciation expenses. Our Loyalty Lab is the center for our research and development activities, and we believe it improves the effectiveness of our loyalty solutions, allows us to work closely with emerging technology and serves as a demonstration center for our clients senior executives.

Historically, our effective tax rate has fluctuated significantly. For some periods, our effective tax rate was unusually high. The high effective tax rates were due primarily to the generation of pre-tax losses in low tax-rate jurisdictions and pre-tax earnings in high tax-rate jurisdictions. During 2000, we began implementing an organizational structure, which we expect to lower our effective tax rate in future years.

Year Ended December 30, 2000 Compared with the Year Ended December 31, 1999

Revenues

Our revenues increased $65.6 million, or 45%, to $211.6 million in 2000 from $146.0 million in 1999. Revenues from professional fees increased $57.3 million, or 41%, to $198.3 million in 2000 from $141.0 million in 1999. The increase in revenues is due to the combined effect of strong demand for the CRM services provided by eLoyalty and higher average billing rates in the period-over-period comparison.

Revenues from Managed Services increased $5.9 million to $7.8 million in 2000 from $1.9 million in 1999. Managed Services revenues represented 4% and 1% of total revenues for the years ended December 30, 2000 and December 31, 1999, respectively. Revenues from software increased $2.4 million to $5.5 million in 2000 from $3.1 million in 1999. Revenues from international operations decreased to approximately 17% of total revenues in 2000, compared to 22% in 1999.

Project Personnel Costs

Project personnel costs increased $35.7 million, or 52%, to $104.2 million in 2000 from $68.5 million in 1999. This is due to an increase in the number of our engageable consultants to 768 as of December 30, 2000, or 37%, from 561 for 1999. Project personnel costs as a percentage of revenues increased to 49% in 2000 compared to 47% in 1999. This was due, in part, to the approximately $5.9 million of incremental project personnel costs incurred in 2000 as part of the expansion of our Managed Services.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased $38.5 million, or 66%, to $96.9 million in 2000 from $58.4 million in 1999. This increase is the result of the growth of eLoyalty and the build-out of eLoyalty s standalone infrastructure, including finance, treasury, legal, human resources and technical systems support, while also making payments to TSC for similar services as part of the shared services agreement during the build-out process. The increase is also due to the continued expansion of our business development group, establishment of the eLoyalty brand in the marketplace and increased uncollectable amounts due from clients, including a $2.8 million incremental charge in the fourth quarter of 2000.

Research and Development Expenses

Research and development expenses increased $3.7 million, or 66%, to $9.3 million in 2000 from $5.6 million in 1999. This increase is primarily due to an increased investment in the Loyalty Lab, including the addition of developers.

Goodwill Amortization

Goodwill amortization expenses were $5.0 million for both 2000 and 1999. Goodwill amortization is primarily attributable to the acquisition of The Bentley Group in 1997.

Other Income (Loss)

eLoyalty recognized non-operating other income of $2.9 million in 2000 compared to a non-operating other loss of $0.4 million in 1999. The $3.3 million increase in non-operating other income is primarily due to incremental interest income earned as a result of higher average cash and cash equivalent balances in 2000 versus 1999. The increase in the average cash balance is due to the cash generated by financing activities, most of which were completed during the first half of 2000.

Income Tax (Benefit) Provision

Income tax (benefit) provision represents combined federal, state and foreign taxes. Due to a pre-tax loss of $0.8 million in 2000, a $0.4 million tax benefit was recognized compared to $4.0 million tax provision recognized in 1999. The effective tax rate remained flat year-over-year.

Net (Loss) Income

eLoyalty reported a net loss of $0.4 million, or $0.01 per share on a diluted basis, for fiscal year 2000 as compared with net income of $4.1 million, or $0.09 per share on a diluted basis, for 1999. The 2000 results are reflective of the $3.8 million operating loss for the fiscal year (as compared to operating income of $8.5 million in 1999), offset in substantial part by the non-operating interest income from investment of increased cash balances obtained through financing activities.

Year Ended December 31, 1999 Compared with the Year Ended December 31, 1998 (Unaudited)

Revenues

Revenues increased $40.8 million, or 39%, to $146.0 million in 1999 from $105.2 million in 1998. Revenues from professional services increased $36.8 million, or 35%, to $141.0 million in 1999 from $104.2 million in 1998. The increase in our revenues reflected increases in both the size and number of client projects, as well as higher average billing rates.

Revenues from software were $3.1 million in 1999 compared to $1.0 million in 1998. Revenues from Loyalty Support increased to $1.9 million in 1999 from $0.0 million in 1998, as we launched our Loyalty Support services during 1999. Revenues from international operations remained consistent, at approximately 22% of total revenues, in both 1999 and 1998.

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Project Personnel

Project personnel costs increased $20.7 million, or 43%, to $68.5 million in 1999 from $47.8 million in 1998. The number of our engageable consultants increased to 561 as of December 31, 1999, or 40%, from 402 at year-end 1998. The increase in project personnel costs in 1999 was also due to an increase in the use of subcontractors, which have a higher average cost, that were required to meet demand. Project personnel costs as a percentage of revenues increased to 47% in 1999 compared to 45% in 1998.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased $11.7 million, or 25%, to $58.4 million in 1999 from $46.7 million in 1998. Selling and marketing expenses increased primarily as a result of our decision to invest in brand building with respect to the launch of our new identity as eLoyalty and to formalize our business development group. We also increased our sales and marketing staff with the launch of our solutions marketing group. General and administrative support expenses increased due to the continued growth of eLoyalty.

Research and Development Expenses

Research and development expenses increased $1.7 million, or 44%, to $5.6 million in 1999 from $3.9 million in 1998. In 1999 we substantially increased our investment in our Loyalty Lab by hiring additional developers and purchasing additional software and hardware.

Goodwill Amortization

Goodwill amortization expense increased $1.2 million, or 32%, to $5.0 million in 1999 from $3.8 million in 1998 related to the acquisition of The Bentley Group.

Income Tax (Benefit) Provision

Income tax (benefit) provision represents combined federal, state and foreign taxes. Our income tax provision increased to $4.0 million on pre-tax profits of $8.1 million in 1999, compared to $1.7 million on pre-tax profits of $2.7 million in 1998. Our effective tax rate was 50% for 1999 and 61% for 1998. This decrease in the effective tax rate was primarily the result of a lower proportion of pre-tax earnings being generated in foreign high tax rate jurisdictions.

Net (Loss) Income

eLoyalty reported net income of $4.1 million, or $0.09 per share on a diluted basis, for fiscal year 1999 as compared with net income of $1.1 million, or $0.02 per share on a diluted basis, for 1998.

Seven Month Period Ended December 31, 1998 Compared with the Seven Month Period Ended December 31, 1997 (Unaudited)

Revenues

Revenues increased $20.7 million, or 47%, to $64.4 million in the seven month period ended December 31, 1998 from $43.7 million in the seven month period ended December 31, 1997. The increase in our revenues of $20.7 million reflected increases in both the size and number of client projects, as well as higher average billing rates.

Revenues from sales of software were $1.0 million in the seven month period ended December 31, 1998 compared to revenues of $0.2 million from sales of software in the seven month period ended December 31, 1997. Revenues from our international operations also significantly contributed to this increase in revenue. In addition, The Bentley Group acquisition contributed approximately $7.8 million of revenues in the seven month period ended December 31, 1997.

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Project Personnel Costs

Project personnel costs increased $8.5 million, or 40%, to $29.6 million in the seven month period ended December 31, 1998 from $21.1 million in the prior year period. The increase in project personnel costs was primarily due to an increase in engageable consultants, as well as higher salaries. Project personnel costs as a percentage of revenues decreased to 46% in the seven month period ended December 31, 1998 compared to 48% in the prior period, principally due to higher utilization of project personnel.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased $10.8 million, or 59%, to $29.1 million in the seven month period ended December 31, 1998 from $18.3 million in the comparable period in the prior year. Selling and marketing expenses increased primarily as a result of establishing our business development group in North America and beginning our sales activities in Europe and Australia. In addition, we established a $2.7 million provision for uncollectable accounts receivable related to revenues generated during the seven month period, largely from clients of The Bentley Group.

General and administrative support expenses increased as eLoyalty launched our operations group to manage utilization, hourly billing rate, revenue per billable employee, employee turnover and day-to-day project pipeline development. During this period, we also increased the support level for our operations in Europe and Australia.

Research and Development Expenses

Research and development expenses increased $1.6 million, or 108%, to $3.1 million in the seven month period ended December 31, 1998 from $1.5 million in the comparable period in the prior year. This increase resulted from the significant expansion of the scope and operations of our Loyalty Lab.

Goodwill Amortization

Goodwill amortization expenses increased $0.6 million, or 32%, to $2.5 million in the seven month period ended December 31, 1998 from $1.9 million in the comparable period in the prior year. This increase was attributable to the contingent purchase price payments related to the acquisitions of The Bentley Group and Aspen Consultancy Ltd.

Income Tax (Benefit) Provision

Income tax provision decreased to $0.4 million on a pre-tax loss of $0.1 million at the end of the seven month period ended December 31, 1998 compared to $0.6 million on pre-tax profits of $0.9 million at the end of the comparable period in the prior year. This unusual income tax provision for the seven month period ended December 31, 1998 resulted from the impact of nondeductible goodwill and expenses, as well as foreign tax rate differences. During the seven months ended December 31, 1998, operations in some foreign jurisdictions incurred taxable losses while other foreign jurisdictions had taxable income. Since deferred tax assets are based on the individual tax jurisdictions in which eLoyalty operates, net operating losses were generated during the period.

Net (Loss) Income

eLoyalty reported a net loss of $0.5 million, or $0.01 per share on a diluted basis, for the seven month period ended December 31, 1998 as compared with net income of $0.3 million, or $0.01 per share on a diluted basis, for the comparable period in the prior year.

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Fiscal Year Ended May 31, 1998 Compared with Fiscal Year Ended May 31, 1997

Revenues

Revenues increased $41.3 million, or 96%, to $84.5 million in the fiscal year ended May 31, 1998 from $43.2 million in the fiscal year ended May 31, 1997. The increase in our revenues reflected increases in both the size and number of client projects. The Bentley Group acquisition contributed $16.4 million of revenues in fiscal year 1998.

Project Personnel Costs

Project personnel costs increased $22.1 million, or 131%, to $39.0 million in fiscal 1998 from $16.9 million in fiscal 1997. The increase in project personnel costs in fiscal 1998 was primarily due to an increase in engageable consultants, as well as higher salaries. Project personnel costs as a percentage of revenues increased to 46% in fiscal 1998 compared to 39% in fiscal 1997. This was due to a substantial increase in our available engageable consultants who we were not able to immediately deploy. The increase in available billable resources was necessary to respond to the growing demand in our North American business.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased $16.1 million, or 84%, to $35.4 million in fiscal 1998 from $19.4 million in fiscal 1997. Selling and marketing expenses increased primarily as a result of our decision to expand our sales and marketing effort in North America while general and administrative support expenses increased due to the continued growth of eLoyalty.

Research and Development Expenses

Research and development expenses increased $0.7 million, or 41%, to approximately $2.5 million in fiscal 1998 from $1.8 million in fiscal 1997. Research and development expenses decreased as a percentage of total revenues to 3% in fiscal 1998 from 4% in fiscal 1997. This percentage decrease resulted from our significant revenue growth in fiscal 1998 and the redeployment of our development staff as engageable consultants to meet the demands of our expanding North American business.

Goodwill Amortization

Goodwill amortization expenses increased $2.8 million to $3.2 million in fiscal 1998 from $0.4 million in fiscal 1997. The increase in goodwill amortization was primarily a result of The Bentley Group acquisition in June 1997.

Net (Loss) Income

eLoyalty reported a net income of $2.2 million, or $0.05 per share on a diluted basis, for fiscal year 1998 as compared with net income of $2.9 million, or $0.06 per share on a diluted basis, for fiscal 1997.

Liquidity and Capital Resources

eLoyalty s principal capital requirements are to fund working capital needs, capital expenditures and other investments in support of revenue generation and growth. Since the spin-off and the associated cessation of operational funding and cash management support from TSC, eLoyalty has been dependent on its own ability to generate capital resources sufficient to meet its ongoing needs for cash.

At December 30, 2000, eLoyalty had cash and cash equivalents of $41.1 million. Although this represented an increase of approximately $27.7 million in cash and cash equivalents from December 31, 1999, the increase was attributable entirely to the $68.3 million cash generated from financing activities, as described below. Both operating activities and investing activities (in capital expenditures) negatively impacted eLoyalty s available 2000 cash resources, with a combined use of such cash resources aggregating nearly $41 million.

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eLoyalty s operating activities used net cash of approximately $22.4 million during fiscal 2000 compared to $11.0 million during 1999. In addition to the negative $0.4 million impact of its net loss for fiscal 2000 and increased needs for cash due to its revenue growth, eLoyalty experienced a $32.9 million (excluding currency effects), or 72%, increase in its net receivables balance compared to that at the prior year-end. This increase is primarily due to the increase in revenues of 50% in the fourth quarter of 2000.

Cash used by eLoyalty in investing activities consisted of capital expenditures of $18.6 million during fiscal 2000 as compared to capital expenditures of $2.2 million for 1999. The substantial increase in capital expenditures for 2000 primarily related to eLoyalty s build-out of its own infrastructure as a stand-alone company, including investments in computer hardware and software, furniture, equipment and leasehold improvements for separate facilities. eLoyalty expects that its capital expenditures for 2001 will be between $12 and $17 million.

eLoyalty has made an additional commitment to invest up to $14.7 million, through another newly formed entity, in eLoyalty Ventures, L.L.C. (eLoyalty Ventures). eLoyalty Ventures is a $30 million venture capital fund formed in 2000 by eLoyalty, together with entities associated with Bain Capital, Sutter Hill Ventures and Technology Crossover Ventures, to focus on investing in early-stage CRM technology companies. eLoyalty has not yet been requested to contribute any of its eLoyalty Ventures commitment and so remains subject to capital calls against that commitment on 10 business days prior written notice.

Cash flows provided by financing activities increased $46.4 million to $68.3 million for fiscal 2000 from $21.9 million in 1999. Cash from such activities increased during fiscal 2000 primarily as a result of two financing events: the issuance of 4.5 million shares of eLoyalty s common stock to venture capital investors for aggregate net proceeds of $34.9 million and a $20 million cash contribution from TSC in connection with the spin-off. Additional cash flows from financing activities were provided by cash proceeds of $8.6 million from the exercise of employee stock options and purchases under eLoyalty s employee stock purchase plan, and $4.8 million in net transfers from TSC in connection with the spin-off, relating to the period from January 1, 2000 to its February 15, 2000 effective date.

eLoyalty s near-term capital resources consist of its current cash balances, together with anticipated future cash flows from operations and availability under an external credit line. eLoyalty s balance of cash and cash equivalents was $41.1 million as of December 30, 2000.

eLoyalty has experienced delays during the first quarter of 2001 in closing both new client engagements and extensions of existing engagements in its North American operations. These delays are expected to contribute to an operating loss and a net loss for the first quarter of 2001. Although eLoyalty does not believe that these delays or the anticipated first quarter net loss is indicative of a material adverse trend in its competitive position or fundamental business, continuing net losses or adverse impacts on its accounts receivable collection activities could require eLoyalty to accelerate use of its existing cash balances to fund operations during 2001 and limit eLoyalty s ability to fund discretionary capital and other expenditures. In response to these economic uncertainties, eLoyalty is assessing various cost reduction actions and on March 5, 2001 announced that it expected in its first quarter of 2001 to recognize a pre-tax charge of approximately $7 million, or $0.08 per share on a diluted basis, related primarily to severance and associated costs.

eLoyalty entered into a business loan agreement with Bank of America, N.A. (the Bank), effective as of December 30, 2000, providing for an unsecured revolving line of credit in a maximum principal amount of $10 million through December 30, 2001 (the Facility). The Facility in effect extended and superseded eLoyalty s prior March 2000 revolving credit agreement with the Bank, which had been guaranteed by TSC and expired on December 30, 2000. eLoyalty s only borrowings under the prior line of credit related to letters of credit required for operational commitments and aggregated $0.7 million at year-end 2000; this aggregate outstanding letter of credit amount was carried forward as outstanding under the Facility. Loans under the Facility bear interest at the Bank s prime rate or, at eLoyalty s election, an alternate rate of IBOR (an offshore U.S. dollar interbank interest rate) plus 0.75%. Under the Facility, eLoyalty agreed to pay a commitment fee of 0.125% of the unused portion of the $10 million commitment and certain other loan fees and expenses.

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The Facility requires eLoyalty to comply with various affirmative and negative covenants, including ones relating to the maintenance of consolidated tangible net worth of at least $70 million, limitations on other liabilities, liens and investments and limitations on aggregate annual lease payments. In addition, eLoyalty agreed to maintain unencumbered liquid assets with an aggregate market value of from 100% to 150% (depending on the nature of such assets and their location) of the total commitment. Accordingly, eLoyalty will be required to maintain at least $10 million in liquid asset coverage throughout 2001 to be in compliance with these covenants and to have credit availability under the Facility.

eLoyalty anticipates that its current cash resources, together with other expected internal and external sources of liquidity, should be sufficient to satisfy eLoyalty s working capital and capital expenditure needs for the balance of the fiscal year. If, however, eLoyalty s operating activities or net cash needs for the year were to differ materially from current expectations, there could be no assurance, given current capital market, credit and general economic uncertainties, that eLoyalty would have access to additional external capital resources on acceptable terms.

Qualitative and Quantitative Disclosures About Market Risk

We provide our solutions to clients in a number of countries including the United States, Canada, United Kingdom, Germany, France and Australia. For the years ended December 2000 and 1999, 17% and 22%, respectively, of our revenues were denominated in foreign currencies. Historically, we have not experienced material fluctuations in our results of operations due to foreign currency exchange rate changes. However, we believe that an increasing portion of our revenues and costs will be denominated in foreign currencies in the future. As a result of our exposure to foreign currencies, our future financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in those foreign markets.

Recent Accounting Pronouncements

On June 15, 1998, the Financial Accounting Standards Board (FASB) issued SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 133, as amended, is effective for fiscal years beginning after June 15, 2000 (2001 for eLoyalty). SFAS No. 133 requires that all derivative instruments be recorded on the balance sheet as assets or liabilities at their fair value. It also requires entities to reflect the gains or losses associated with changes in the fair value of derivatives each period, either in current earnings or as a separate component of other comprehensive income, depending on the nature of the underlying contract or transaction. eLoyalty anticipates that the adoption of SFAS No. 133 will not have a material effect on its results of operations, financial position or cash flows.

Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements (SAB 101), provides guidance in applying generally accepted accounting principles to selected revenue recognition issues in financial statements. On June 26, 2000, the SEC issued SAB 101B, an amendment to SAB 101 which delayed the implementation of SAB 101 until no later than the fourth fiscal quarter of fiscal years beginning after December 15,1999. The implementation of SAB 101 had no material effect on eLoyalty.

Year 2000 Considerations

eLoyalty knows of no significant Year 2000 related failures which have affected eLoyalty-provided software or services or internal eLoyalty systems. Due to the large number of software and systems solutions engagements eLoyalty has undertaken over the years, there can be no assurance that all such software and systems will be Year 2000 compliant or that eLoyalty may not be subject to future claims as a result.

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Factors That May Affect Future Results or Market Price of Stock

Some of the factors that may affect eLoyalty s future results or the market price of its stock and cause or contribute to material differences between actual results and those reflected in forward-looking statements contained in this report include the following:

uncertainties associated with the attraction of new clients, the continuation of existing and new engagements with existing clients and the timing of related client commitments, including potential client delays or deferrals of new engagements or existing project extensions in light of prevailing general economic conditions and uncertainties;

reliance on major clients and suppliers, and maintenance of good relations with key business partners;

management of the risks associated with increasingly complex client projects in general as well as new services offerings, including risks relating to the variability and predictability of the number, size, scope, cost and duration of, and revenues from, client engagements, unanticipated cancellations or deferrals of client projects or follow-on phases of engagements in process, collection of billed amounts, shifts from time and materials-based engagements to alternative pricing or value-based models and variable employee utilization rates, project personnel costs and project requirements;

management of growth, expansion into new geographic and market areas and development and introduction of new services offerings, including the timely and cost-effective implementation of enhanced operating, financial and other infrastructure systems and procedures;

challenges in attracting, training, motivating and retaining highly skilled management, strategic, technical, product development and other professional employees in a competitive information technology labor market;

continuing intense competition in the information technology services industry generally and, in particular, among those focusing on the provision of CRM services and software, including both firms with significantly greater financial and technical resources than eLoyalty and new entrants;

the rapid pace of technological innovation in the information technology services industry, including frequent technological advances and new product introductions and enhancements, and the ability to create innovative and adaptable solutions that are consistent with evolving standards and responsive to client needs, preferences and expectations;

access in tightening capital and credit markets to sufficient debt and/or equity capital to meet eLoyalty s future operating and financial needs;

protection of eLoyalty s technology, proprietary information and other intellectual property rights or challenges to eLoyalty s intellectual property by third parties;

future legislative or regulatory actions relating to the information technology or information technology services industries;

risks associated with global operations, including those relating to the economic conditions in each country, potential currency exchange and credit volatility, compliance with a variety of foreign laws and regulations and management of a geographically dispersed organization;

the overall demand for CRM services and software and information technology generally; and

the continued impact of the current economic slowdown, as well as other future general business, capital market and economic conditions and volatility.

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Appendix E

EXCERPTS FROM QUARTERLY REPORT ON FORM 10-Q

FOR FISCAL QUARTER ENDED JUNE 30, 2001

1. Financial Statements

eLoyalty Corporation

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)

	June 30, 2001	December 30, 2000
	(Unaudited)	
ASSETS:		
CURRENT ASSETS:		
Cash and cash equivalents	$39,652	$41,138
Marketable securities	9,574	9,902
Receivables (less allowances of $1,944 and $1,605, respectively)	39,451	75,886
Deferred income taxes	6,044	16,301
Prepaid expenses	2,627	2,935
Refundable income taxes	9,025	4,619
Other current assets	1,670	2,915
Total current assets	108,043	153,696
Equipment and leasehold improvements, net	18,538	18,784
Goodwill, net	4,345	6,990
Deferred income taxes	9,904	2,664
Long-term receivables and other	2,255	2,484
Total assets	$143,085	$184,618
LIABILITIES AND STOCKHOLDERS EQUITY:		
CURRENT LIABILITIES:		

Short-term debt	$8,600	$
Accounts payable	5,511	6,880
Accrued compensation and related costs	16,210	19,964
Deferred compensation	9,519	9,897
Other current liabilities	6,406	7,021
Total current liabilities	46,246	43,762
Long term liabilities	3,072	
Commitments and contingencies		
STOCKHOLDERS EQUITY:		
Preferred stock, $.01 par value; 10,000,000 shares authorized; none issued and outstanding		
Common stock, $.01 par value; 100,000,000 shares authorized; 51,661,163 and 49,925,702 shares issued and outstanding respectively	517	499
Additional paid-in capital	147,542	144,860
(Accumulated deficit) retained earnings	(44,219)	2,171
Other	(10,073)	(6,674)
Total stockholders equity	93,767	140,856
Total liabilities and stockholders equity	$143,085	$184,618

The accompanying Notes to Condensed Consolidated Financial Statements

are an integral part of this financial information.

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eLoyalty Corporation

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2001	2000	2001	2000
	(Unaudited)		(Unaudited)	
Revenues	$34,981	$50,960	$81,227	$97,139
Project personnel costs	22,531	24,908	51,098	46,089
Gross profit	12,450	26,052	30,129	51,050
Other costs and expenses:				
Selling, general and administrative	20,466	22,512	50,047	44,370
Severance and related costs	10,719		22,194	
Research and development	2,121	2,300	4,616	4,328
Goodwill amortization				

1,241 1,242 2,485 2,488

34,547 26,054 79,342 51,186

Operating (loss)	(22,097)	(2)	(49,213)	(136)
Other net income	692	815	1,232	1,261
(Loss) income before income taxes	(21,405)	813	(47,981)	1,125
Income tax provision (benefit)	8,508	407	(1,591)	563
Net (loss) income	$(29,913)	$406	$(46,390)	$562
Net (loss) income per share:				
Basic	$(0.60)	$0.01	$(0.93)	$0.01

Diluted	$(0.60)	$0.01	$(0.93)	$0.01
Shares used to calculate basic net (loss) income per common share	49,979	47,850	49,964	46,875
Shares used to calculate diluted net (loss) income per common share	49,979	53,134	49,964	52,618

The accompanying Notes to Condensed Consolidated Financial Statements

are an integral part of this financial information.

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eLoyalty Corporation

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	For the Six Months Ended June 30, 2001	2000
	(Unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net (loss) income	$(46,390)	$562
Adjustments to reconcile net (loss) income to net cash used in operating activities:		
Depreciation and amortization	6,034	3,230
Provision for uncollectible amounts	2,908	(61)
Severance and related costs	22,194	
Deferred income taxes	2,624	(5,118)
Changes in assets and liabilities:		
Receivables	32,547	(8,144)
Sales (purchases) of trading securities related to deferred compensation program	328	(2,085)
Other current assets	(4,477)	(1,250)
Accounts payable	(1,330)	4,750
Accrued compensation and related costs	(15,036)	4,778
Deferred compensation funds from employees	(378)	2,085
Other current liabilities	(7,373)	4,132
Other long-term assets	224	(876)
Long term liabilities	3,072	
Net cash (used in) provided by operating activities	(5,053)	2,003

CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(5,527)	(5,792)
Net cash used in investing activities	(5,527)	(5,792)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from revolving credit agreement	9,000	
Repayments on revolving credit agreement	(400)	
Proceeds from stock compensation plans	1,022	6,164
Proceeds from issuance of common stock		34,817
Capital contribution from Technology Solutions Company		20,000
Net advances from Technology Solutions Company		4,565
Net cash provided by financing activities	9,622	65,546
Effect of exchange rate changes on cash and cash equivalents	(528)	(1,749)

(Decrease) increase in cash and cash equivalents	(1,486)	60,008
Cash and cash equivalents, beginning of period	41,138	13,462
Cash and cash equivalents, end of period	$39,652	$73,470

The accompanying Notes to Condensed Consolidated Financial Statements

are an integral part of this financial information.

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eLoyalty Corporation

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (In thousands, except share and per share data)

Note 1 General

In the opinion of management, the accompanying unaudited condensed consolidated financial statements of eLoyalty Corporation (we or eLoyalty) include all normal and recurring adjustments necessary for a fair presentation of our consolidated financial position as of June 30, 2001, the consolidated results of our operations for the three months and six months ended June 30, 2001 and 2000, and our cash flows for the six months ended June 30, 2001 and 2000, and are in conformity with Securities and Exchange Commission (SEC) Rule 10-01 of Regulation S-X. The financial statements include the combined results of operations, cash flows and financial position for the period prior to February 15, 2000, when we operated within Technology Solutions Company (TSC), and subsequent to February 15, 2000, when we operated as a separate, publicly traded company. Certain reclassifications have been made to the second quarter and year-to-date 2000 condensed consolidated statement of operations to conform to the 2001 presentation.

The results of operations for any interim period are not necessarily indicative of the results for the full year. The accompanying financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto in the Company s Annual Report on Form 10-K for the fiscal year ended December 30, 2000.

Note 2 Comprehensive Net Loss

Comprehensive net loss is comprised of the following:

	For the Three Months Ended June 30,	For the Six Months Ended June 30,

	2001	2000	2001	2000
	(Unaudited)		(Unaudited)	
Net (loss) income	$(29,913)	$406	$(46,390)	$562
Other comprehensive loss:				
Effect of currency translation	(287)	(1,158)	(2,242)	(2,557)
Comprehensive net loss	$(30,200)	$(752)	$(48,632)	$(1,995)

The accumulated other comprehensive loss, which represents the cumulative effect of foreign currency translation adjustments, was $4.2 million at June 30, 2001 and $2.0 million at December 30, 2000.

Note 3 (Loss) Earnings Per Share

The following table sets forth the computation of the shares used in the calculation of our basic and diluted (loss) earnings per share:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2001	2000	2001	2000
	(Unaudited)		(Unaudited)	
Weighted average common shares outstanding	49,979	47,850	49,964	46,875
Common stock equivalents	591	5,284	1,562	5,743

Weighted average common and common share equivalents
50,570 53,134 51,526 52,618

In periods in which there is a loss, we do not include common stock equivalents in the diluted (loss) earnings per share calculation as they are anti-dilutive.

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eLoyalty Corporation

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

Note 4 Segment Information

We operate in one business segment focused exclusively on providing customer relationship management (CRM) related consulting services. Beginning in 2001 as a result of organizational changes, we have two reportable geographic segments. Those segments are: North America and International. Our North American business includes our United States and Canadian operations. Our International business includes operations in Europe and Australia. The following table reflects revenues, operating results, and total assets by reportable segment for the three months and six months ended June 30, 2001 and June 30, 2000, respectively.

For the Three Months Ended June 30, (unaudited)	North America	International	Total
Revenues			
2001	$29,862	$5,119	$34,981
2000	$45,402	$5,558	$50,960
Operating income (loss)			
2001	$(14,472)	$(7,625)	$(22,097)
2000	$3,746	$(3,748)	$(2)

For the Six Months Ended June 30, (unaudited)	North America	International	Total
Revenues			
2001			

$66,513 $14,714 $81,227
2000
$87,146 $9,993 $97,139
Operating income (loss)

2001
$(37,882) $(11,331) $(49,213)
2000
$8,262 $(8,398) $(136)

As of June 30, (unaudited)	North America	International	Total

Total assets

2001
$126,589 $16,496 $143,085
2000
$154,185 $21,490 $175,675

Note 5 Severance and related costs

We recognized a $10.7 million pre-tax charge in the second quarter of 2001 as a result of cost reduction actions taken in the second quarter. This is in addition to the $11.5 million charge taken in the first quarter of 2001. These charges relate to employee severance payments and related costs for approximately 250 employees, primarily in the North American segment. They also relate to the closure and downsizing of various offices. Severance costs include contractual salary and related fringe benefits over the severance payment period, forgiveness of employee loans and outplacement costs. Facility costs primarily include expected losses on contractual lease commitments, net of sublease revenues, and write down of leasehold improvements. Other costs include laptop and other computer lease termination costs, legal expenses and the write down of deposits related to outside services, which have been terminated. During the six months ended June 30, 2001, we made cash payments of $7.4 million and reduced our headcount by approximately 250 employees related to this cost reduction action. Of these payments, $5.9 million was expended in the second quarter of 2001. We expect substantially all severance and related costs to be paid out by the end of fourth quarter of 2001 pursuant to agreements entered into with affected employees, and facility costs related to the office closures to be paid pursuant to contractual lease terms through 2007.

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eLoyalty Corporation

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

The following table represents a reconciliation of these charges, accumulated usage and the reserve balance at June 30, 2001:

	Q1/Q2 Charges	Accumulated Usage	Reserve Balance
Employee severance	$11,888	$7,115	$4,773

Facility
6,696 2,933 3,763
Other
3,610 1,567 2,043

Total	$22,194	$11,615	$10,579

In addition, on July 31, 2001, we announced an estimated $7.6 million pre-tax charge to be taken in the third quarter of 2001 relating primarily to severance benefits associated with a reduction in force affecting approximately 155 employees, which was communicated to affected employees in July. This additional severance-related charge is expected to be substantially paid out by the fourth quarter of 2001.

Note 6 Income Taxes

During the second quarter of 2001, we established a $12.2 million valuation allowance against the benefit of certain international operating unit tax losses recognized through March 31, 2001 and ceased recording the benefit of losses incurred by these operating units beginning in the second quarter of fiscal 2001. The decision was made following a company-wide review of potential financial results by geography under various alternative scenarios and related assessment and based on relevant accounting guidelines regarding the certainty of recoverability of these net deferred tax assets in light of the period over which they arose and the predictability of a near-term return of international operating units to acceptable, continuing levels of profitability.

We have recorded a deferred tax asset of $15.9 million reflecting primarily the benefit of U.S. loss carryforwards, which expire in 2020. Realization is dependant on generating sufficient taxable income in the U.S. prior to expiration of these loss carryforwards. Although realization is not assured, we believe that is more likely than not that all of the deferred tax asset will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if current estimates of the timing and amount of future taxable income during the carryforward period are significantly revised.

Note 7 Restricted Stock Grants

On April 2, 2001, eLoyalty s Board of Directors approved the grant of 1,265,000 shares of restricted stock at a fair market value of $1.75 per share to certain officers under the eLoyalty Corporation 1999 Stock Incentive Plan. These shares are subject to a restriction period from the date of grant, during which the shares may not be sold, assigned, pledged or otherwise encumbered. Of the 1,265,000 shares granted, 915,000 shares vest over a period of 48 equal monthly installments beginning May 1, 2001. The remaining 350,000 shares vest in 48 equal monthly installments beginning May 1, 2003.

Note 8 Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards (SFAS) No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets, SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. SFAS No. 142 eliminates the systematic amortization of goodwill and indefinite lived intangible assets and requires them to be tested for impairment at least annually. Separable intangible assets that are not deemed to have an indefinite life will continue to be amortized over their useful lives. We

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eLoyalty Corporation

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

will adopt SFAS No. 141 effective July 1, 2001 and SFAS No. 142 effective January 1, 2002. We have not completed an evaluation of the financial statement effect of adopting SFAS No. 142.

Note 9 Subsequent Event

We terminated our Executive Deferred Compensation Plan effective as of July 15, 2001, and provided for all participant account balances to be distributed in a lump sum following the termination effective date. We also terminated an associated Executive Benefit Trust, effective on completion of distributions from the plan. This nonqualified deferred compensation plan allowed eligible participants (employees at or above the level of Vice President) to defer receipt of a portion of their cash compensation. We expect all distributions from this plan to be completed before September 30, 2001. Investments purchased by eLoyalty with the deferred compensation funds and the corresponding obligations to participants, including investment earnings thereon, are reflected as assets and liabilities, respectively, on our balance sheet under the captions Marketable Securities and Deferred Compensation.

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

Forward-Looking Statements

The following Management s Discussion and Analysis contains forward-looking statements that are based on current management expectations, forecasts and assumptions. These include, without limitation, statements containing the words believes, anticipates, estimates, expects, plans, intends, projects, future and similar expressions, references to plans, strategies, objectives and anticipated future performance and other statements that are not strictly historical in nature. These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or implied by the forward-looking statements. Such risks, uncertainties and other associated factors that might cause such a difference include, but are not limited to, those noted under Factors That May Affect Future Results or Market Price of Stock included later in this Appendix. Readers should also carefully review the risk factors described in other documents eLoyalty files from time to time with the SEC, including our Annual Report on Form 10-K for the fiscal year ended December 30, 2000 and our subsequent Quarterly Report on Form 10-Q.

Readers are cautioned not to place undue reliance on these forward-looking statements. They reflect opinions, assumptions and estimations only as of the date they are made, and eLoyalty undertakes no obligation to publicly update or revise any forward-looking statements in this report, whether as a result of new information, or future events or circumstances.

Background

eLoyalty is a global management consulting and systems integration organization focused exclusively on building customer loyalty. eLoyalty has a broad range of customer relationship management (CRM) related services including business strategy, technical architecture, selection, implementation and integration of appropriate CRM software applications and provision of ongoing support for multi-vendor systems.

eLoyalty was spun off from Technology Solutions Company (TSC) into a separate, publicly traded company on February 15, 2000 (the spin-off). Accordingly, the statements of operations for periods subsequent to the spin-off reflect eLoyalty s results as a stand-alone company. The statements of operations for periods prior to the spin-off are presented as if eLoyalty operated as a separate entity, and includes a cost allocation of certain TSC general corporate expenses that were not directly related to eLoyalty s operations. These costs were allocated proportionately to eLoyalty based on revenues and headcount.

Performance Overview and General Outlook

Our consolidated revenues were $35.0 million in the second quarter of 2001. This represents an approximate 31% decline as compared to the second quarter of 2000 and a 24% decline from the first quarter of 2001, which in turn followed a 20% sequential quarterly decline from the fourth quarter of 2000. This second consecutive sequential quarterly revenue decline followed a period of 45% revenue growth for fiscal 2000, and returns eLoyalty to its lowest quarterly revenue level since the second quarter of 1999. As a result, average revenues per billable day for the second quarter of 2001 were $547,000, down from $723,000 for the first quarter of 2001 and $945,000 for the fourth quarter of 2000 and lower than the respective averages for fiscal 2000 and 1999. The sequential quarterly 2001 revenue declines have been primarily attributable to significant delays and deferrals of new client projects and extensions, which we believe reflect the impact of broader negative economic conditions on both client expenditure commitments and client decision time frames for information technology related projects and consulting services.

We have experienced sequential declines during 2001 in the utilization rate of our engageable field consultants, partially mitigated by our cost reduction activities so far this year. Utilization is defined as billed time as a percentage of total available time. Average utilization was 68%, 66%, 60% and 54% for the second quarter 2000, fiscal year 2000, first quarter 2001, and second quarter 2001, respectively. Our gross profit margin (gross profits, or revenues minus project personnel costs, as a percentage of revenues) was 36% for the second quarter of 2001. This represented a decline from both our 38% gross profit margin in the first quarter of

2001 and the 51% gross profit margin achieved for fiscal 2000. We continue to experience pricing competition similar to that in the first quarter, and our second quarter average hourly billing rate remained flat at $210 per hour from the first quarter of 2001. That rate, however, reflected a 10% ($234 to $210) decline from that in the fourth quarter of 2000, which represented the highest average quarterly rate achieved during last year.

As previously announced, in early June, Agilent Technologies notified us of its cancellation of a project on which we and other third parties were engaged. Agilent had been our single largest customer, contributing approximately $8 million, or 22.8%, of our total revenues for the second quarter of 2001 and approximately 19% and 15%, respectively, of our total revenues for the first quarter of 2001 and the prior fiscal year. Given current economic and demand conditions, this project cancellation is expected to have a material near-term effect on our revenues, beginning in the third fiscal quarter of this year. In general, this year as our revenues have declined, demand from prospective new clients softened and our major account planning focus sharpened, our customer concentration has grown, increasing our potential exposure to the loss of a single major customer. During the second quarter of 2001, two clients (in addition to Agilent) each accounted for more than 10% of our revenues. Our top 20 customers contributed 92% of total revenues for the second quarter of 2001, as compared to 85% for the first quarter of 2001 and 70% for the second quarter last fiscal year.

We presently expect the current economic slowdown and resulting uncertain client expenditure commitments and extended decision time frames to persist during the remainder of 2001 and to continue into 2002. We are continuing to experience deferrals of proposed new projects and project extensions at a level commensurate with the fist quarter of 2001, with pipeline prospects being converted into firm engagements at a less certain rate and on a longer cycle than during prior years. In addition, while we expect our North American segment (which has historically accounted for more than 80% of our consolidated revenues) to continue to suffer from these adverse conditions, we also have begun to experience in the second quarter of 2001 some of the same uncertainties and accompanying demand softness in Europe and other international business locations. Accordingly, we expect our consolidated revenues for the third quarter of 2001 to be flat to slightly down from the second quarter, after excluding the effects of the earlier described project cancellation.

In response to this economic environment and demand slowdown, we have undertaken a number of cost reduction activities, including headcount reductions and office closures and downsizing. As a result of those activities, we recognized a special pre-tax charge of $10.7 million (approximately $7.1 million after tax) in the second quarter of fiscal 2001. Approximately 75% of this $10.7 million special charge relates to future 2001 cash commitments for agreed employee severance payments and estimated contractual exit costs associated with office closures. This second quarter charge is in addition to the special pre-tax charge of $11.5 million (approximately $7.1 million after-tax) taken in the first quarter of fiscal 2001.

During July 2001, we initiated further cost reduction actions, including an additional workforce reduction. We expect that these July actions will result in an estimated pre-tax special charge of approximately $7.6 million ($5.5 million after-tax) in the third quarter of fiscal 2001. As a result of these combined year-to-date actions, we have reduced our overall headcount by approximately 38%, from 1,018 total employees at the end of fiscal 2000 to approximately 630 employees at the end of July 2001. We expect substantially all severance and related costs to be paid out by the end of this fiscal year pursuant to agreements entered into with the affected employees and the costs related to the office closures to be paid pursuant to contract terms through 2007.

During the second quarter of 2001, we established a $12.2 million valuation allowance against the benefit of certain international operating unit tax losses recognized through March 31, 2001 and ceased recording the benefit of losses incurred by these operating units beginning in the second quarter of fiscal 2001. The decision was made following a company-wide review of potential financial results by geography under various alternative scenarios and a related assessment, based on relevant accounting guidelines, of the certainty of recoverability of these net deferred tax assets in light of the period over which they arose and the predictability of a near-term return of international operating units to acceptable, continuing levels of profitability.

Primarily as a result of the above-described business conditions and the responsive cost reduction actions, we experienced a second quarter 2001 operating loss of $22.1 million, compared to essentially break even for the comparable quarter last fiscal year. The net loss for the second quarter, including the after-tax effect of the

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special and valuation allowance charges, was $29.9 million, or $ 0.60 per share on a diluted basis, compared to net income of $0.4 million, or $0.01 per share on a diluted basis, for the second quarter of 2000.

We intend to closely monitor our pipeline during the ensuing fiscal quarters and may take additional cost reduction actions based on business demand and then current economic conditions. In addition, we are evaluating capital structure and financing alternatives, including among others the possibility of raising of additional equity capital from existing or new investors, to address the prospect of a sustained economic downturn and applicable Nasdaq stock market listing maintenance requirements. See Liquidity and Capital Resources below.

Results of Operations

Second Quarter 2001 Compared with Second Quarter 2000

Revenues

We reported revenues at $35.0 million in the second quarter of 2001 versus $51.0 million in same quarter last year. Revenues were down, $16 million or 31%, due to the general economic slowdown and the resulting decrease in technology investments. eLoyalty s revenues are generated primarily from professional services, which are billed principally on a time and materials basis. Revenues are recognized for time and material engagements as services are rendered. eLoyalty has, on occasion, contracted projects on a fixed fee or not-to-exceed fee basis.

Professional service fee revenues decreased $15.1 million, or 31%, in the quarter-over-quarter comparison to $33.0 million in the second quarter of 2001 from $48.1 million in the year-ago second quarter. Professional service fee revenues have also declined in comparison to the last three quarters for which such revenues were $54.4 million, $54.4 million, and $44.2 million. This sequential professional service fee revenue decrease in the second quarter of 2001 is believed to be the result of generally reduced spending on information technology and consulting services.

Other revenue contributors include fees generated from Managed Services (including Loyalty Support services, purpose-built hosted solutions and e-PROFILE) and the licensing of proprietary software. Revenues from Managed Services were $2.0 million, or 6% of second quarter 2001 revenues, and $1.4 million, or 3% of second quarter 2000 revenues. This $0.6 million increase is the result of increased emphasis on improving recurring revenue streams. Software revenues decreased $1.5 million to zero in the current-year period compared to the prior-year period, representing a continuing decline in software revenues.

North American revenues decreased 34% to $29.9 million in the current year quarter from $45.4 million in the prior-year quarter. Seven customers accounted for 76% of the second quarter 2001 North American revenues. In comparison, North American revenues were $49.6 million, $48.7 million, and $36.6 million, respectively, for the third and fourth quarters of 2000 and the first quarter of 2001. This sequential decline in revenues is believed due to the continued poor economic climate described above.

International revenues decreased 9% to $5.1 million in the second quarter of 2001 from $5.6 million in the second quarter of 2000. International revenues were $7.2 million, $8.9 million and $9.6 million, respectively, for the third and fourth quarters of 2000 and the first quarter of 2001. Second quarter 2001 International revenues represent a sequential quarterly decline of 47% from the first quarter of fiscal 2001, reflecting that our International segment has begun to experience softening demand due to economic uncertainties like those prevailing for some time in North America. With our International revenue declines and key account planning, the result has been an increase in our International segment s customer concentration. Approximately 80% of International revenues were derived from four customers during the second quarter of 2001.

Project personnel costs and gross profits

eLoyalty s most significant operating cost is project personnel costs, which comprise labor costs including salaries, fringe benefits and incentive compensation of engageable consultants, as well as fees paid to subcontractors for work performed on an engagement.

Project personnel costs decreased $2.4 million, or 9.6%, to $22.5 million in the second quarter of 2001 from $24.9 million in the prior-year second quarter. The current period decrease in project personnel costs is due in substantial part to the headcount and other cost reduction actions primarily affecting our North American operations. (See Severance and related costs below). As a result of these headcount reductions, the total number of engageable consultants was 572 at June 30, 2001 compared to approximately 665 at June 30, 2000. Further headcount reductions occurred in July of 2001, which resulted in total engageable consultants at July 31, 2001 of approximately 490.

Project personnel costs as a percentage of revenues increased to 64% in the current year period compared to 49% in the comparable prior-year period, primarily due to a decline in sales volume and decrease in the utilization of engageable consultants.

North American project personnel costs decreased to $17.7 million during the second quarter of 2001 compared to $21.2 million in the prior-year quarter. As a percentage of revenues, project personnel costs for North America were 59% in the second quarter of 2001 versus 47% in the prior-year quarter. This is due to the decline in sales volume and lower utilization in light of the economic slowdown described above.

International project personnel costs increased to $4.8 million in the current year quarter from $3.7 million in the prior-year quarter. As a percentage of revenues, project personnel costs were 94% of revenues in the second quarter of 2001 versus 67% in the prior year quarter. This is attributable largely to the same factors as affected our North American project personnel costs in the second quarter of 2001.

Gross profits represent our revenues less project personnel costs. Our gross profits have declined in recent years, reflecting in part the adverse impact of subcontractor use and non-billable time incurred by project personnel. Gross profit margins also experienced a decline in the second quarter of 2001, decreasing to 36% from 51% in the second quarter of 2000. Gross profits for North American operations decreased to $12.2 million in the second quarter of 2001 from $24.2 million in the prior-year second quarter, due primarily to reduced revenues and lower utilization. International gross profit decreased to $0.3 million in the current year period from $1.8 million in the prior-year second quarter period, reflecting lower utilization of engageable consultants in the second quarter of 2001.

Selling, general and administrative

Selling, general and administrative expenses consist primarily of salaries, incentive compensation and employee benefits for business development, marketing, managerial and administrative personnel, plus provisions for uncollectible amounts. Other overhead expenses consist of employee costs for training, travel expenses, laptop computer leases and other non-billable expenses not directly related to projects or research and development. For 2000, this would also include expenses relating to administrative and other support services provided by TSC as part of a shared services agreement.

Selling, general and administrative expenses decreased $2.0 million, or 9%, to $20.5 million in the second quarter of 2001 from $22.5 million in the prior-year quarter. In the second quarter of 2000, we began the build-out of our infrastructure as a separate company; thus our general and administrative costs were higher in 2000 reflecting some duplicate costs while we also paid for TSC shared services. The benefits of our headcount reductions (See Severance and related costs below) are also reflected in these 2001 results.

Severance and related costs

We recognized a $10.7 million pre-tax charge in the second quarter of 2001 as a result of cost reduction actions. This also relates to the closure and downsizing of various offices and certain employee severance benefits relating to workforce reduction activities communicated to the affected employees in the second quarter of fiscal 2001. The facility closure costs primarily include expected losses on contractual lease commitments, net of sublease revenues, and the write-down of leasehold improvements. Severance costs include contractual salary and related fringe benefits over the severance payment period, forgiveness of employee loans and outplacement costs. Other costs include laptop and other computer equipment lease termination costs, legal expenses and the write down of deposits related to outside services, which have been

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terminated. This charge was in addition to the $11.5 million charge in the first quarter of 2001. We expect substantially all severance and related costs to be paid out by the end of fourth quarter of 2001 pursuant to agreements entered into with affected employees.

In addition, we announced an estimated $7.6 million pre-tax charge to be taken in the third quarter of 2001 relating primarily to severance benefits associated with the employment termination of approximately 155 additional employees communicated to affected employees in July. The severance related charges are expected to be paid out by the fourth quarter of 2001. We anticipate our annualized cost savings from the reduction of salaries, benefits, and facility lease payments related to all of the above mentioned cost reduction actions to be $56 million.

Research and development

Research and development expenses consist primarily of salaries, incentive compensation and employee benefits for dedicated personnel, staff recruiting costs, administrative costs, travel expenses and depreciation expenses. Our Loyalty Lab is the center of our research and development activities, and we believe it improves the effectiveness of our loyalty solutions, allows us to work closely with emerging technology and serves as a demonstration center for our clients.

Research and development expenses decreased $0.2 million, or 9%, to $2.1 million in second quarter of 2001 from $2.3 million in the prior-year quarter, primarily due to the headcount actions mentioned above.

Goodwill amortization

Goodwill amortization expenses were $1.2 million for both the second quarter of 2001 and 2000. Goodwill amortization is primarily attributable to the acquisition of the Bentley Group in 1997.

Operating loss

We recognized an operating loss of $22.1 million in the second quarter of 2001 compared to essentially break even in the prior-year second quarter. The current quarter s operating loss is attributable primarily to a special charge associated with cost reduction actions, reduced revenues and lower utilization of engageable consultants.

North America had an operating loss of $14.5 million in the second quarter of 2001 versus operating income of $3.7 million in the second quarter of 2000. International experienced an operating loss of $7.6 million in the second quarter of 2001 versus an operating loss of $3.7 million in the second quarter of 2000. These decreases in operating income are due to reduced revenues, lower utilization and a special charge as described above.

Other income

We recognized non-operating other income of $0.7 million in the second quarter of 2001 versus $0.8 million in the year ago quarter. Other income remained flat due to higher investment yields, offset by lower average invested cash balances and interest paid on short-term debt during the second quarter 2001 compared to the same period in 2000.

Income tax (benefit) provision

We recorded a valuation allowance of $14.4 million relating to our international deferred tax assets. This reserve is for deferred taxes resulting from losses prior to March 31, 2001 ($12.2 million) plus additional valuation allowance of $2.2 million for certain international net operating loss carryforwards generated in the second quarter of 2001. Due to the recognition of this valuation allowance, we recognized an income tax provision of $8.5 million versus a provision of $0.4 million in the second quarter of 2000.

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First Six Months of 2001 Compared with First Six Months of 2000

Revenues

Revenues decreased $15.9 million, or 16%, to $81.2 million in the first six months of 2001 from $97.1 million in the prior-year period. Professional service fee revenues decreased $11.9 million in the year-over-year comparison to $77.2 million in 2001 from $89.1 million in the year-ago period. Other revenue contributors include fees generated from Managed Services (including Loyalty Support services, purpose-built hosted solutions and e-PROFILE). Revenues from Managed Services in the first six months of 2001 and 2000 were $3.7 million, or 5% of total 2001 revenues, and $2.8 million, or 3% of total 2000 revenues. Revenues from software sales decreased $4.8 million to $0.4 million in the current-year period from $5.2 million in the prior-year period. The $15.9 million decrease in total revenues is believed primarily due to the overall softening of demand for technology investments as a result of ongoing economic uncertainties.

North American revenues decreased 24% to $66.5 million in the first six months of 2001 from $87.1 million in the prior-year period. This general decline in revenues is believed to result primarily from ongoing economic uncertainties as described above.

International revenues increased to $14.7 million, or 18.1% of total revenues, in the first six months of 2001, from $10.0 million, or 10% of total revenues, in the prior-year period. This increase is due primarily to the fact that our international segment experienced stronger revenues in the first quarter of 2001, but did experience a decline in demand due to current economic uncertainties comparable to that in North America in the second quarter of fiscal 2001.

Project personnel costs and gross profits

Project personnel costs increased $5.0 million, or 11%, to $51.1 million in the first six months of 2001 from $46.1 million in the prior-year period. The current-year increase in project personnel costs is primarily due to a significant higher level in the number of billable employees in first quarter of 2001, partially offset by headcount reductions made in March and April of 2001. Project personnel costs as a percentage of revenues increased to 63% in the six months ended June 30, 2001 compared to 47% in the prior-year period, primarily due to a 16% revenue decline.

North American project personnel costs increased to $41.8 million during the six months ended June 30, 2001 compared to $38.3 million in the prior-year period. As a percentage of revenues, project personnel costs for North America were 63% in the six months ended June 30, 2001 versus 44% in the prior year period. The deterioration of these percentages is due to the decline in volume and lower utilization from the economic slowdown described above.

International project personnel costs increased to $9.3 million for the six months ended June 30, 2001 versus $7.8 million in the prior-year period. As a percentage, project personnel costs were 63% of revenues in the six months ended June 30, 2001 versus 78% in the prior year period. The improvement in this percentage is due to the headcount reductions mentioned above and increased revenue in the six months ended June 30, 2001.

Selling, general and administrative

Selling, general and administrative expenses increased $5.6 million, or 13%, to $50.0 million in the first six months of 2001 from $44.4 million in the prior-year period. Selling and marketing expenses increased period-over-period as a result of our continued expansion of the business development group. General and administrative expenses increased in the period-over-period comparison, primarily due to the build-out of our corporate infrastructure, finance, treasury, legal, human resources, technical support and management personnel additions, and an increase in non-labor related expenses attributable to growth in billable consultants, which continued through the second quarter of 2001. Beginning in the first quarter of 2001, we initiated certain cost reductions as discussed above which resulted in a reduction in our selling, general and administrative expenses in the second quarter of 2001. However, the impact did not fully offset the increased expense in the first quarter of 2001 as compared to the first quarter last fiscal year. As a result of the foregoing, selling, general and administrative expenses increased as a percentage of revenues to 62% in the current-year period from 46% in the prior-year period.

Severance and related costs

We recognized $22.2 million in pre-tax charges in the first six months of 2001 as a result of cost reduction actions taken in the first and second quarters. These charges relate to severance benefits and the closure and downsizing of various offices. During the six months ended June 30, 2001, we made cash payments of $7.4 million and reduced our headcount by approximately 250 employees related to these cost reduction actions. We expect substantially all severance and related costs to be paid out by the end of fourth quarter of 2001 pursuant to agreements entered into with affected employees and office closures costs to be paid pursuant to contract terms through 2007.

Research and development expenses

Research and development expenses increased $0.3 million, or 7%, to $4.6 million in the first six months of 2001 from $4.3 million in the prior-year period. Research and development expenses increased as a percentage of revenues from 4.5% in the prior-year period to 5.7% in the current-year period, primarily due to our increased investment in the first quarter of 2001. This percentage increase is also the result of the 16% decline in revenues for the comparable six-month period.

Goodwill amortization

Goodwill amortization expenses remained relatively flat at $2.5 million in both the first six months of 2001 and 2000, respectively. Goodwill amortization is primarily attributed to the acquisition of the Bentley Group.

Operating loss

We recognized an operating loss of $49.2 million for the six months ended June 30, 2001 compared to an operating loss of $0.1 million in the prior year period. This incremental operating loss is attributable primarily to the above described special charges associated with cost reduction actions taken by management, reduced revenues and lower utilization of engageable consultants.

North America had an operating loss of $37.9 million in the six months ended June 30, 2001 versus the prior-year period income of $8.3 million. International experienced an operating loss of $11.3 million for the six months ended June 30, 2001 versus an operating loss of $8.4 million for the first six months of 2000. These decreases in operating income are due to reduced revenues, lower utilization and special charges as described above.

Other income

eLoyalty recognized non-operating other income of $1.2 million in the first six months of 2001 compared to non-operating other income of $1.3 million in the prior-year period. Other income remained relatively flat due to higher investment yields, offset by lower average invested cash balances and interest paid on short term debt during the first six months of 2001 compared to the same period in 2000.

Income tax (benefit) provision

The benefit from income taxes was $1.6 million in the first six months of 2001 compared to $0.6 million provision in the prior-year period, primarily as a result of the tax benefits associated with the losses incurred thus far in 2001, partially offset by the recognition of a second quarter 2001 $14.4 million valuation allowance related to certain international net operating loss carryforwards.

Liquidity and Capital Resources

eLoyalty s principal capital requirements are to fund working capital needs, capital expenditures and other investments in support of revenue generation and growth. Since the spin-off and the associated cessation of operational funding and cash management support from TSC, we have been dependent on our own ability to generate capital resources sufficient to meet our ongoing needs for cash.

Our principal current capital resources consist of our cash and cash equivalent balances. At June 30, 2001, we had cash and cash equivalents of approximately $39.7 million, which included the net proceeds of $8.6 million borrowed under our revolving credit line as of that date (described below). Excluding the additional cash from these borrowings, our cash and cash equivalents position declined by approximately $10.0 million in the first six months of 2001, from $41.1 million at December 30, 2000 to $31.1 million at June 30, 2001.

Net cash of $5.1 million was used by operations for the first six months of fiscal 2001, compared to $2.0 million of cash provided by operations during the prior-year period. Our negative operating cash flows in the current-year period were primarily attributable to the substantial $46.4 million net loss we sustained for the first six months of 2001, offset by a decrease in receivables as a result of improved collection efforts and by the inclusion of a total of $22.2 million of special charges recorded during the period. Approximately $4.8 million of the recorded special charges for the first six months of fiscal 2001 and $5.7 million of the anticipated third quarter charge represents future cash commitments for employee severance payments that are expected to become payable, and be charged against cash from operations, in subsequent quarters of fiscal 2001. In addition, $3.6 million of recorded special charges represented future cash commitments which will become payable and be charged against operating cash flows in periods 2002 through 2007.

Cash flows used by eLoyalty in investing activities consisted solely of capital expenditures of $5.5 million for the first six months of fiscal 2001, a decline of $0.3 million from the $5.8 million of capital expenditures in the prior-year period. Capital expenditures were higher in the prior-year period, primarily reflecting the commencement of our fiscal 2000 infrastructure build-out, including investments in computer hardware and software, furniture, equipment and leasehold improvements for separate facilities. Total capital expenditures are expected to approximate $9 million in fiscal 2001, as compared to $18.6 million during fiscal 2000.

eLoyalty has made an additional commitment to invest up to $14.7 million, through another newly formed entity, in eLoyalty Ventures, L.L.C. (eLoyalty Ventures). eLoyalty Ventures is a $30 million venture capital fund formed in 2000 by eLoyalty, together with entities associated with Bain Capital, Sutter Hill Ventures and Technology Crossover Ventures, to focus on investing in early-stage customer relationship management technology companies. eLoyalty has not yet been requested to contribute any of its eLoyalty Ventures commitment and so remains subject to capital calls against that commitment on 10 business days prior written notice. We do not expect any capital calls to be made during the remainder of 2001.

Cash flows provided by financing activities totaled $9.6 million the first six months of fiscal 2001, a decrease of $55.9 million from the $65.5 million of cash from financing activities for the same period last year. Of that $9.6 million, $8.6 million was attributable to net borrowings under our revolving credit facility, repayable not later than December 30, 2001. The balance of the cash flows from financing activities for the first six months of 2001 related to proceeds received in connection with stock option exercises and purchases under the eLoyalty employee stock purchase plan. In comparison, cash flows provided by financing activities in the first six months of fiscal 2000 included: a $20 million cash contribution from TSC in connection with its spin-off of eLoyalty on February 15, 2000; proceeds of $34.8 million received from the sale of eLoyalty common stock to venture capital investors; $6.2 million received from stock compensation plans; and $4.6 million in net transfers from TSC to fund operations prior to the spin-off. During fiscal 2000, the increases in eLoyalty s cash resources were attributable entirely to the $68.3 million in cash generated during the year from financing activities, the bulk of which derived from one-time financing events as described above.

Our $8.6 million in net borrowings as of June 30, 2001 was drawn down under the business loan agreement we entered into with Bank of America, N.A. (the Bank) as of December 30, 2000. This loan

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agreement provides for an unsecured revolving line of credit in a maximum principal amount of $10 million through December 30, 2001 (the Facility). As of June 30, 2001, we had only $0.7 million of credit remaining available for borrowing under the Facility, as a result of our 2001 net borrowings and four outstanding letters of credit, totaling $0.7 million, securing office space in the United States, Europe and Australia.

Among its other financial covenants, the Facility requires us to maintain $70 million of consolidated tangible net worth. Reserves against assets, such as the $12.2 million income tax valuation allowance recorded in the second quarter of fiscal 2001, and operating losses (which reflect the special charges described above) negatively impact net worth and, accordingly, the tangible net worth covenant calculation. Due in part to such allowance and operating losses, our consolidated tangible net worth, as we calculate it for purposes of this covenant, exceeded the minimum $70 million requirement by approximately $17 million as of June 30, 2001 and by approximately $16 million as of July 28, 2001. As we anticipate a third quarter special charge as described above, we expect that our tangible net worth (as so calculated) may decline further, absent offsetting increases to net tangible assets. Accordingly, if current economic and demand conditions continue to adversely affect our operations, we may be unable to maintain compliance with this tangible net worth covenant and, unless we are successful in renegotiating this covenant or obtaining a waiver from the Bank, we may be required to repay the full amount outstanding under the Facility before the end of this fiscal year.

In addition, the Facility requires us to maintain unencumbered liquid assets with an aggregate market value of from 100% to 150% (depending on the nature of such assets and their location) of the total commitment. Accordingly, we will be required to maintain at least $10 million in unencumbered liquid asset coverage throughout 2001 to remain in compliance with this covenant. Other principal terms of the loan and its covenants are summarized in response to Item 8 of our Form 10-K for the year ended December 30, 2000.

On August 2, 2001, we received a letter from The Nasdaq Stock Market (Nasdaq) notifying us that we had failed to maintain a minimum closing bid price of $1.00 over the previous thirty day period, a requirement for continued Nasdaq listing. The letter further noted that we would be given until October 31, 2001 to restore our compliance with this requirement, by maintaining a minimum bid price of $1.00 for at least a ten-day period prior to such date. If we are unable to do so, we will be notified that our securities will be delisted from Nasdaq. We would have the right to appeal any such decision. Such a delisting of our common stock would negatively impact its liquidity and, as a result, may adversely affect our stock price and our ability to raise additional capital.

We anticipate that our current cash resources should be sufficient to satisfy our expected working capital and capital expenditure needs for the next twelve months. Despite our recent cost reduction activities, however, continuing operating and net losses or adverse impacts on our accounts receivable collection activities resulting from uncertain prevailing economic conditions and project deferrals could require us to accelerate use of existing cash balances to fund operations for the next twelve months and limit our ability to fund capital and other discretionary expenditures. If our operating activities or net cash needs for the year were to differ materially from current expectations, there could be no assurance, given current market, credit and general economic uncertainties, that we would have access to additional capital resources on acceptable terms. As noted above under Performance Overview and General Outlook, we are currently evaluating various capital structure and financing alternatives, including potential equity capital financing from existing or new investors.

Year 2000 Considerations

eLoyalty knows of no significant Year 2000 related failures that have affected eLoyalty provided software or services or internal eLoyalty systems. Due to the large number of software and systems solutions engagements we have undertaken over the years, there can be no assurance that all such software and systems will be Year 2000 compliant or that we may not be subject to future claims as a result.

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Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards (SFAS) No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets, SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. SFAS No. 142 eliminates the systematic amortization of goodwill and indefinite lived intangible assets and requires them to be tested for impairment at least annually. Separable intangible assets that are not deemed to have an indefinite life will continue to be amortized over their useful lives. We will adopt SFAS No. 141 effective July 1, 2001 and SFAS No. 142 effective January 1, 2002. We have not completed an evaluation of the financial statement effect of adopting SFAS No. 142.

Factors That May Affect Future Results or Market Price of Stock

Some of the factors that may affect our future results or the market price of our stock and cause or contribute to material differences between actual results and those reflected in forward-looking statements contained in this report include the following:

- Uncertainties associated with the attraction of new clients, the continuation of existing and new engagements with existing clients and the timing of related client commitments, including potential client delays or deferrals of new engagements or existing project extensions in light of prevailing general economic conditions and uncertainties;

reliance on a relatively small number of customers for a significant percentage of our revenues, reliance on major suppliers, including CRM software providers and other alliance partners, and maintenance of good relations with key business partners;

management of the risks associated with increasingly complex client projects in general as well as new services offerings, including risks relating to the variability and predictability of the number, size, scope, cost and duration of, and revenues from, client engagements, unanticipated cancellations or deferrals of client projects or follow-on phases of engagements in process, collection of billed amounts, shifts from time and materials-based engagements to alternative pricing or value-based models and variable employee utilization rates, project personnel costs and project requirements;

management of growth, expansion into new geographic and market areas and development and introduction of new services offerings, including the timely and cost-effective implementation of enhanced operating, financial and other infrastructure systems and procedures;

challenges in attracting, training, motivating and retaining highly skilled management, strategic, technical, product development and other professional employees in a competitive information technology labor market;

continuing intense competition in the information technology services industry generally and, in particular, among those focusing on the provision of CRM services and software, including both firms with significantly greater financial and technical resources than eLoyalty and new entrants;

the rapid pace of technological innovation in the information technology services industry, including frequent technological advances and new product introductions and enhancements, and the ability to create innovative and adaptable solutions that are consistent with evolving standards and responsive to client needs, preferences and expectations;

access in tightened capital and credit markets to sufficient debt and/or equity capital on acceptable terms to meet our future operating and financial needs, and uncertainties relating to our future ability to maintain compliance with existing net worth and liquid asset coverage and other covenants under our current bank revolving credit agreement or negotiate acceptable alternative terms or waivers;

uncertainties regarding both the return and maintenance of our stock price at a higher minimum bid price level sufficient to maintain our Nasdaq Stock Market listing and the effectiveness of any actions we may take to address the same;

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protection of our technology, proprietary information and other intellectual property rights or challenges to our intellectual property by third parties;

future legislative or regulatory actions relating to the information technology or information technology services industries including those relating to data privacy;

maintenance of our reputation and expansion of our name recognition in the marketplace;

risks associated with global operations, including those relating to the economic conditions in each country, potential currency exchange and credit volatility, compliance with a variety of foreign laws and regulations and management of a geographically dispersed organization;

the overall demand for CRM services and software and information technology consulting services generally; and

the continued impact of the current economic slowdown, as well as other future general business, capital market and economic conditions and volatility.

3. Quantitative and Qualitative Disclosures About Market Risk

We provide solutions to clients in a number of countries including the United States, Canada, United Kingdom, Germany, France and Australia. For the quarters ended June 30, 2001 and 2000, 18% and 16%, respectively, of our revenues were denominated in foreign currencies. Historically, we have not experienced material fluctuations in our results of operations due to foreign currency exchange rate changes. However, we believe that an increasing portion of revenues and costs will be denominated in foreign currencies in the future. As a result of our exposure to foreign currencies, future financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in those foreign markets.

We also have interest rate risk with respect to changes in variable rate interest on our revolving line of credit. Interest on the line of credit is based on IBOR which varies in accordance with prevailing market conditions. A change in interest rate impacts the interest expense on the line of credit and cash flows, but does not impact the fair value of the debt.

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eLOYALTY CORPORATION
SPECIAL MEETINGS OF STOCKHOLDERS
, 2001
9:00 A.M., CENTRAL TIME

REVOCABLE PROXY

THIS PROXY IS SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS
FOR THE , 2001 SPECIAL MEETING OF THE STOCKHOLDERS

The undersigned hereby appoints Kelly D. Conway and Timothy J. Cunningham, or either of them, as proxies, each with full power of substitution, to represent the undersigned and vote for and on behalf of the undersigned the number of shares of common stock of eLoyalty Corporation (eLoyalty) held of record on , 2001 and which the undersigned would be entitled to vote if personally present at the special meeting of stockholders to be held on , 2001 at 9:00 A.M., Central Time, at eLoyalty s principal executive offices, 150 Field Drive, Suite 250, Lake Forest, Illinois, and at any adjournments or postponements thereof.

IF YOU VOTE BY PHONE OR INTERNET, PLEASE DO NOT MAIL YOUR PROXY CARD

Please detach here

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR EACH OF THE FOLLOWING PROPOSALS.

The undersigned directs that this proxy be voted as follows:

(1) A proposal to approve the issuance and sale by eLoyalty of up to $25.0 million of 7% Series B convertible preferred stock pursuant to the share purchase agreement, dated as of September 24, 2001, with several funds affiliated with Technology Crossover Ventures and several funds affiliated with Sutter Hill Ventures, and the issuance of shares of common stock upon the conversion of the Series B convertible preferred stock.

[ ] For [ ] Against [ ] Abstain

(2) A proposal to approve an amendment to eLoyalty s Certificate of Incorporation, as amended, to increase the number of authorized shares of eLoyalty s common stock, par value $0.01 per share, from 100,000,000 shares to 500,000,000 shares and to increase the number of authorized shares of eLoyalty s preferred stock, par value $0.01 per share, from 10,000,000 shares to 40,000,000 shares.

[ ] For [ ] Against [ ] Abstain

(3) A proposal to approve the amendment of eLoyalty s Certificate of Incorporation, as amended, to effect a one-for-ten stock combination, or reverse stock split, with respect to all of the issued shares of eLoyalty common stock and a corresponding decrease in the number of eLoyalty s authorized shares of common stock to one-tenth the amount authorized immediately prior to the amendment.

[ ] For [ ] Against [ ] Abstain

eLoyalty will not effect Proposals 1 or 2 unless Proposals 1, 2 and 3 are all approved and are being implemented. eLoyalty may take action on Proposal 3 if it is approved, even if Proposals 1 and 2 are not approved or implemented.

In their discretion, the holders of this proxy are authorized to vote upon such other business as may come before the meeting.

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The shares of stock represented by this proxy will be voted as specified above, unless otherwise directed. The undersigned hereby revokes any proxy or proxies heretofore given for such stock and ratifies and confirms all that the above-named proxies or their substitutes may lawfully do by virtue hereof.