

WORKBRAIN CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF INTERIM FINANCIAL RESULTS
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2004 AND 2003

You should read the following management's discussion and analysis ("MD&A") in conjunction with our interim consolidated financial statements for the three and nine month periods ended September 30, 2004 and the notes thereto, and with our annual audited consolidated financial statements, including the notes thereto, and our annual MD&A for the year ended December 31, 2003.

Forward-looking Statements

Certain statements included in this document constitute forward-looking statements, including those identified by the expressions *anticipate, believe, plan, estimate, expect, intend* and similar expressions to the extent they relate to us or our management. These forward-looking statements are not historical facts but reflect our current expectations regarding future results or events. These forward-looking statements are subject to a number of risks and uncertainties that could cause actual results or events to differ materially from current expectations, including the matters discussed in our annual MD&A under *Risk Factors*.

Overview

Workbrain develops, markets, implements, and supports software that helps large organizations optimally deploy and manage their workforces. Our solutions automate workforce management processes such as labour forecasting, employee schedule optimization, time and attendance, workforce analytics and employee self-service. We market and sell our products through both direct and indirect channels to maximize market coverage in a cost-effective manner. We have a direct sales force that sells our software in North America, Europe and Australia. Our sales channels are supported through marketing and implementation relationships with leading systems integrators and Business Process Outsourcers (BPOs).

Comparison of Three Months Ended September 30, 2004 and 2003

Revenue:

Total revenue increased 78.7% to \$16.0 million in the three months ended September 30, 2004 from \$9.0 million in the three months ended September 30, 2003.

Licence revenue increased 62.0% to \$4.1 million in the three months ended September 30, 2004 compared with \$2.6 million in the three months ended September 30, 2003. The growth was substantially attributable to an increase in our cumulative number of new customers, which totaled 85 at September 30, 2004 compared with 52 at September 30, 2003. Growth was also a result of significant investments in sales infrastructure, primarily an increase in the number of direct sales personnel as well as a substantial expansion of marketing programs. We expect licence revenue to increase in dollar amounts as we expect to continue to add new customers and continue to invest in sales infrastructure in future periods.

Service, maintenance and other revenue increased 85.4% to \$11.9 million in the three months ended September 30, 2004 compared with \$6.4 million in the three months ended September 30, 2003. The increase was primarily attributable to additional product implementation projects related to new customers as well as a growing installed base, which provides recurring maintenance and hosting revenue.

Cost of revenue:

Cost of licence revenue decreased 63.2% to \$7,000 in the three months ended September 30, 2004 compared with \$19,000 in the three months ended September 30, 2003, and represented 0.2% and 0.7% of licence revenue, respectively. The decrease in the dollar amount and as a percentage of licence revenue of the cost of licence revenue reflected the sale of fewer third-party software licenses in the three months ended September 30, 2004 compared with the same period of the prior year.

Cost of service, maintenance and other revenue increased 72.2% to \$7.8 million in the three months ended September 30, 2004 compared with \$4.5 million in the three months ended September 30, 2003, and

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represented 65.3% and 70.4% of service, maintenance and other revenue, respectively. These increases related primarily to the increase in the number of implementation, customer support, training and hosting personnel and related costs necessary to support our larger customer base and new and pending product implementations. The average number of customer support, implementation and training personnel grew to 219 in the three months ended September 30, 2004 compared with 134 at September 30, 2003. The cost of service, maintenance and other revenue included a foreign exchange gain of \$382,000 in the three months ended September 30, 2004 compared to a foreign exchange loss of \$(179,000) in the three months ended September 30, 2003. In future periods, we expect the cost of service, maintenance and other revenue to increase in absolute terms as we service our growing customer base, but to decrease as a percentage of revenue.

Cost of revenue accruals (recoveries), net was \$nil in the three months ended September 30, 2004 compared with \$(911,000) in the three months ended September 30, 2003. The decrease in dollar amount occurred because no contracts were accounted for under the zero-profit method during the three months ended September 30, 2004. We expect the amounts of any future accrual or recovery of zero-profit provisions to be negligible, since all projects where revenue was recognized using the zero-profit method are now substantially complete.

Operating expenses:

Sales and marketing expenses increased 54.6% to \$3.2 million in the three months ended September 30, 2004 compared with \$2.1 million in the three months ended September 30, 2003, and represented 20.2% and 23.3% of net revenue, respectively. The increase in dollar amount was primarily attributable to the expansion of our sales and marketing workforce, which grew to an average of 66 personnel in the three months ended September 30, 2004 compared with an average of 62 in the three months ended September 30, 2003, increases in their related travel expenses in both North America and abroad, and increased marketing activities, trade shows and promotional expenses. The decrease as a percentage of net revenue is due to increased productivity of our existing sales and marketing personnel offsetting rapid expansion of our sales and marketing staff. We expect sales and marketing expenses to increase in dollar amount in future periods as we expect to continue to add to our sales force and increase our marketing activities in North America and abroad.

Research and development expenses increased 65.2% to \$2.3 million in the three months ended September 30, 2004 compared with \$1.4 million in the three months ended September 30, 2003, and represented 14.1% and 15.3% of net revenue, respectively. The increase in dollar amount in the three months ended September 30, 2004 over the prior year was primarily attributable to increased staffing and associated support invested in order to expand and enhance our product offering. The average number of research and development personnel grew to 98 in the three months ended September 30, 2004 compared with 51 in the three months ended September 30, 2003. Research and development expenses included of a foreign exchange gain of \$208,000 in the three months ended September 30, 2004 compared to a foreign exchange loss of \$(73,000) in the three months ended September 30, 2003. We intend to increase research and development expenditures in dollar amount in future periods as we expect to continue to enhance our products and introduce new functionality.

General and administrative expenses increased 299.7% to \$1.3 million in the three months ended September 30, 2004 compared with \$319,000 in the three months ended September 30, 2003, and represented 8.0% and 3.6% of net revenue, respectively. These increases were attributable to an increase in the average number of administrative and financial personnel, to 41 in the three months ended September 30, 2004 compared with 24 in the three months ended September 30, 2003, and to increases in professional fees and other general corporate expenses necessary to manage and support our growth. General and administrative costs included a foreign exchange gain of \$230,000 in the three months ended September 30, 2004 compared with a foreign exchange gain of \$513,000 included in general and administrative expenses in the three months ended September 30, 2003. We anticipate that general and administrative expenses will

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increase in dollar amount in future periods in order to support the continuing growth we expect in our customer base.

Amortization of acquisition-related intangibles was \$75,000 in the three months ended September 30, 2004, compared with \$127,000 for the same period of the prior year. This expense relates to our acquisition of the net operating assets of Workforce Logistics Inc. in April 2003, which enhanced our existing workforce management solution with additional schedule optimization functionality. We intend to continue to pursue selective strategic acquisitions that will expand and add functionality to our product offerings, augment our distribution channels, expand our market opportunity and/or broaden our customer base. We have no present agreements or commitments with respect to any prospective acquisition or investment.

Amortization of stock-based compensation increased to \$368,000 for the three months ended September 30, 2004 compared with \$nil in the three months ended September 30, 2003 and represented 2.3% and 0.0% of net revenue, respectively. The increase in dollar amount and as a percentage of net revenue was the result of the adoption of a new accounting standard that requires that, beginning on January 1, 2004, we expense the fair value of stock options granted to employees since January 1, 2002 over the estimated vesting period of the stock options.

Interest income, net increased to \$204,000 in the three months ended September 30, 2004 compared with \$50,000 in the three months ended September 30, 2003. The increase in interest income was primarily due to an increase in cash balances in the three months ended September 30, 2004 compared with the three months ended September 30, 2003. We will continue to invest in accordance with our investment policy, which emphasizes liquidity and the minimization of risk.

Foreign exchange. We maintain a Canadian dollar denominated treasury to fund our Canadian denominated operating expenses, in addition to our U.S. dollar-denominated treasury. As a result, we are subject to gains and losses due to fluctuations in the exchange rate between the U.S. and Canadian dollars. We recorded a net foreign exchange gain of approximately \$891,000 for the three months ended September 30, 2004 which was primarily as a result of an appreciation in the value of the Canadian dollar over the period (from 0.7460 U.S. dollars at June 30, 2004 to 0.7912 U.S. dollars at September 30, 2004). As we continue to expand our operations internationally, we will be subjected to additional potential gains and losses against currencies other than the U.S. dollar, in addition to our exposure to the Canadian dollar.

Net income. Net income decreased by \$248,000 to \$1.2 million in the three months ended September 30, 2004 compared with net income of \$1.5 million in the three months ended September 30, 2003. The decrease was primarily due to cost of revenue recoveries of \$nil in the three months ended September 30, 2004, compared to \$911,000 in the three months ended September 30, 2003, which reflects the discontinuation of the zero-profit revenue recognition method described above. The decrease was also due to the inclusion of a stock-based compensation expense of \$368,000 in the three months ended September 30, 2004, compared to \$nil in the three months ended September 30, 2003, due to the adoption of the new accounting standard described above.

Pro-forma net income. Pro-forma net income decreased by \$622,000 to \$795,000 in the three months ended September 30, 2004 compared with pro forma net income of \$1.4 million in the three months ended September 30, 2003. The decrease was primarily due to the discontinuation of the zero-profit revenue recognition method described above.

Pro-forma net loss is a non-GAAP measure related to net loss and is defined as net loss excluding foreign exchange charges, stock-based compensation charges and amortization of acquisition related intangibles. We believe that this measure enhances an overall understanding of our operational results and trends. Pro-forma net loss is a supplemental measure and should not be construed as an alternative to net income as defined under Canadian generally accepted accounting principles (Canadian GAAP) as a measure of profitability. Our method of measuring pro-forma net loss is unlikely to be comparable to similar measures

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provided by other companies. A reconciliation of the Canadian GAAP information to the pro-forma information is provided in the following table (tabular amounts in thousands of U.S. dollars):

	<u>Three months ended September 30,</u>	
	<u>2004</u>	<u>2003</u>
Net income	\$ 1,243	\$ 1,491
Add back:		
Foreign exchange gain	(891)	(201)
Amortization of stock-based compensation	368	-
Amortization of acquisition-related intangibles	75	127
Pro-forma net income	<u>\$ 795</u>	<u>\$ 1,417</u>

Comparison of Nine Months Ended September 30, 2004 and 2003

Revenue:

Total revenue increased 61.2% to \$39.2 million in the nine months ended September 30, 2004 from \$24.3 million in the nine months ended September 30, 2003.

Licence revenue increased 52.7% to \$12.0 million in the nine months ended September 30, 2004 from \$7.8 million in the nine months ended September 30, 2003. The growth was substantially attributable to an increase in the number of customers to 85 at September 30, 2004 compared with 52 at September 30, 2003. Growth was also a result of significant investments in sales infrastructure, primarily an increase in the number of direct sales personnel as well as a substantial expansion of marketing programs.

Service, maintenance and other revenue increased 65.3% to \$27.2 million in the nine months ended September 30, 2004 from \$16.5 million in the nine months ended September 30, 2003. The increase was primarily attributable to additional product implementation projects related to new customers as well as a growing installed base, which provides recurring maintenance and hosting revenue.

Cost of revenue:

Cost of licence revenue decreased 28.7% to \$199,000 in the nine months ended September 30, 2004 compared with \$279,000 in the nine months ended September 30, 2003, and represented 1.7% and 3.6% of licence revenue, respectively. The decrease in the dollar amount and as a percentage of licence revenue of the cost of licence revenue reflected the sale of fewer third-party software licenses in the nine months ended September 30, 2004 compared with the same period of the prior year.

Cost of service, maintenance and other revenue increased 60.7% to \$19.5 million in the nine months ended September 30, 2004 compared with \$12.1 million in the nine months ended September 30, 2003, and represented 71.7% and 73.7% of service, maintenance and other revenue, respectively. The increase in the cost of service, maintenance and other revenue in dollar amount in the nine months ended September 30, 2004 related primarily to the increase in the number of implementation, customer support, training and hosting personnel and related costs necessary to support our larger customer base and new and pending product implementations. The average number of customer support, implementation and training personnel grew to 188 in the nine months ended September 30, 2004 compared with 123 at September 30, 2003. The decrease in the cost of service, maintenance and other as a percentage of service, maintenance and other revenue in the nine months ended September 30, 2004 related primarily to an increase in the billable utilization of our resources compared with the nine months ended September 30, 2003. The cost of service, maintenance and other revenue also included a foreign exchange loss of \$(193,000) in the nine months ended September 30, 2004 compared to a foreign exchange gain of \$386,000 in the nine months ended September 30, 2003.

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Cost of revenue accruals (recoveries), net was \$(168,000) in the nine months ended September 30, 2004 compared with (\$553,000) in the nine months ended September 30, 2003. The cost of revenue accruals (recoveries), net, in the nine months ended September 30, 2004 results from the reversal, during 2004, of zero-profit provisions made in prior years related to a project substantially completed during 2004. The cost of revenue accruals (recoveries), net, in the nine months ended September 30, 2003 results from the accrual of zero-profit provisions related to progress, during 2003, on an on-going project where the zero-profit method was applied.

Operating expenses:

Sales and marketing expenses increased 55.6% to \$9.7 million in the nine months ended September 30, 2004 compared with \$6.2 million in the nine months ended September 30, 2003, and represented 24.7% and 25.6% of net revenue, respectively. The increase in dollar amount was primarily attributable to the expansion of our sales and marketing workforce, which grew to an average of 62 personnel in the nine months ended September 30, 2004 compared with an average of 49 in the nine months ended September 30, 2003, increases in their related travel expenses in both North America and abroad, and increased marketing activities, trade shows and promotional expenses. The decrease as a percentage of net revenue is due to the increased productivity of our sales and marketing activities.

Research and development expenses increased 102.8% to \$7.0 million in the nine months ended September 30, 2004 compared with \$3.4 million in the nine months ended September 30, 2003, and represented 17.8% and 14.2% of net revenue, respectively. The increase in dollar amount in the nine months ended September 30, 2004 over the prior year was primarily attributable to increased staffing and associated support invested in order to expand and enhance our product offering. The average number of research and development personnel grew to 91 in the nine months ended September 30, 2004 compared with 55 in the nine months ended September 30, 2003. Research and development expenses also included a foreign exchange loss of \$(97,000) in the nine months ended September 30, 2004 compared to a foreign exchange gain of \$182,000 in the nine months ended September 30, 2003.

General and administrative expenses increased 163.2% to \$3.5 million in the nine months ended September 30, 2004 compared with \$1.3 million in the nine months ended September 30, 2003, and represented 8.9% and 5.4% of net revenue, respectively. These increases were attributable to an increase in the average number of administrative and financial personnel, to 38 in the nine months ended September 30, 2004 compared with 24 in the nine months ended September 30, 2003, and to increases in professional fees and other general corporate expenses necessary to manage and support our growth. General and administrative expenses included a foreign exchange gain of \$292,000 in the nine months ended September 30, 2004 compared with a foreign exchange gain of \$1.1 million in the nine months ended September 30, 2003.

Amortization of acquisition-related intangibles was \$292,000 in the nine months ended September 30, 2004, compared with \$211,000 for the same period of the prior year. This expense relates to our acquisition of the net operating assets of Workforce Logistics Inc. in April 2003, which enhanced our existing workforce management solution with additional schedule optimization functionality.

Amortization of stock-based compensation increased to \$917,000 for the nine months ended September 30, 2004 compared with \$3,000 in the nine months ended September 30, 2003 and represented 2.3% and 0.0% of net revenue, respectively. The increase in dollar amount and as a percentage of net revenue was the result of the adoption of a new accounting standard that requires that, beginning on January 1, 2004, we expense the fair value of stock options granted to employees since January 1, 2002 over the estimated vesting period of the stock options.

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Interest income increased to \$689,000 in the nine months ended September 30, 2004 compared with \$170,000 in the nine months ended September 30, 2003. The increase in interest income was primarily due to an increase in cash balances in the nine months ended September 30, 2004 compared with the nine months ended September 30, 2003.

Foreign exchange. Since the completion of our initial public offering in December 2003, we have maintained a Canadian dollar denominated treasury in addition to our U.S. dollar-denominated treasury. We use those Canadian dollars to fund our Canadian denominated operating expenses. We are subject to gains and losses due to fluctuations between the U.S. and Canadian dollars. We recorded a net foreign exchange loss of approximately \$(52,000) for the nine months ended September 30, 2004 as a result of changes in the value of various currencies as compared to the U.S. dollar over the period.

Net income (loss). Net loss for the nine months ended September 30, 2004 was \$1.0 million, compared to net income of \$1.4 million in the nine months ended September 30, 2003. The decrease was primarily due to two items: a foreign exchange loss of \$(52,000) included in the nine months ended September 30, 2004, compared to a foreign exchange gain of \$1.7 million included in the same period of the prior year; and the inclusion of a stock-based compensation expense of \$917,000 in the nine months ended September 30, 2004 due to the adoption of the new accounting standard described above.

Pro-forma net income (loss). Pro-forma net income for the nine months ended September 30, 2004 was \$269,000 compared to pro-forma net loss of \$(97,000) in the nine months ended September 30, 2003. The increase was primarily due to an improvement, after the exclusion of the impact of foreign exchange, in our gross margin to 50.6% in the nine months ended September 30, 2004 from 49.6% in the same period of the prior year.

Pro-forma net loss is a non-GAAP measure related to net loss and is defined as net loss excluding foreign exchange charges, stock-based compensation charges and amortization of acquisition related intangibles. We believe that this measure enhances an overall understanding of our operational results and trends. Pro-forma net loss is a supplemental measure and should not be construed as an alternative to net income as defined under Canadian GAAP as a measure of profitability. Our method of measuring pro-forma net loss is unlikely to be comparable to similar measures provided by other companies. A reconciliation of the Canadian GAAP information to the pro-forma information is provided in the following table (tabular amounts in thousands of U.S. dollars):

	Nine months ended June 30,	
	<u>2004</u>	<u>2003</u>
Net income (loss)	\$ (992)	\$ 1,424
Add back:		
Foreign exchange (gain) or loss	52	(1,735)
Amortization of stock-based compensation	917	3
Amortization of acquisition-related intangibles	292	211
Pro-forma net income (loss)	<u>\$ 269</u>	<u>\$ (97)</u>

Liquidity and Capital Resources

At September 30, 2004 we had cash and cash equivalents and short-term investments of \$45.6 million and working capital of \$43.2 million.

Cash provided by (used in) operating activities for the three months ended September 30, 2004 and 2003 and the nine months ended September 30, 2004 and 2003 was \$(817,000), \$684,000, \$(1.6 million) and \$837,000, respectively. Cash used by operations in the three months ended September 30, 2004 was primarily the result of increases in working capital requirements, primarily an increase in accounts receivable. Cash provided by operations in the three months ended September 30, 2003 was primarily the

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result of the net income in the period, which was partially offset by increased working capital requirements. Cash used in operations in the nine months ended September 30, 2004 was primarily the result of increases in working capital requirements, primarily an increase in accounts receivable. Cash provided by operations in the nine months ended September 30, 2003 was primarily the result of net income for the period and non-cash depreciation and amortization charges for the period, which were partially offset by increased working capital requirements.

Investment activities during the three months ended September 30, 2004 and 2003 and the nine months ended September 30, 2004 and 2003 included cash used for the purchase of property and equipment totaling \$702,000, \$443,000, \$2.1 million and \$1.6 million, respectively. We expect that our investment in property and equipment will continue to increase as our employee base and customer base continue to grow. Cash (used by) provided by the sale (purchase) of short-term investments during the three months ended September 30, 2004 and 2003 and the nine months ended September 30, 2004 and 2003, were \$(32.3 million), \$(8.4 million), \$(25.6 million) and \$504,000, respectively. In the nine months ended September 30, 2003, \$1.4 million of cash was used to fund a portion of the purchase price of the acquisition of Workforce Logistics Inc.

Financing activities during the three months ended September 30, 2004 and 2003 and the nine months ended September 30, 2004 and 2003 consisted primarily of the issuance of share capital pursuant to stock option exercises which totaled \$436,000, \$2,000, \$1.2 million and \$413,000, respectively. In the nine months ended September 30, 2004, \$1.5 million of cash was provided by the sale and leaseback of property and equipment. During Q2-2004, the Company negotiated a non-committed lease line of credit for up to \$2.4 million with the equipment finance arm of a Canadian chartered bank to finance selected property and equipment purchases. At September 30, 2004, a total of \$1.4 million had been advanced to the Company in two transactions under the line at a fixed interest rate of approximately 6% for initial terms of 36 months. Under the agreement, advances bear interest at fixed or floating benchmark rates plus 2%. Capital lease obligations are secured by the equipment that has been financed.

We believe that our current cash and short-term investments and anticipated cash flow from operations will be sufficient to meet our working capital and capital expenditure requirements for the foreseeable future.

Operating Lease Commitments In October 2004, the Company entered into an agreement to amend its current lease of office space at its current level for an extended term. This resulted in an increase in our future minimum lease payment commitments of approximately \$2.1 million to a total commitment of \$3.8 million, extending to October 2010. The Company will also be responsible for certain common area costs at its various leased premises.

Litigation The Company is subject to legal proceedings and claims that arise in the ordinary course of its business. While management currently believes the amount of ultimate liability, if any, with respect to these actions will not materially affect the financial position, results of operations, or liquidity of the Company, the ultimate outcome of any litigation is uncertain. Were an unfavorable outcome to occur, the impact could be material to the Company. The Company does not believe that it is probable that a liability has been incurred nor does it believe that the amount of any loss can be reasonably estimated. Accordingly, no liability has been accrued for these matters.

Share capital at September 30, 2004 consisted of 16,972,003 common shares issued and outstanding.