SABA SOFTWARE INC
Form 10-Q
April 09, 2008
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended February 29, 2008

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to .

000-30221

(Commission File number)

SABA SOFTWARE, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**94-3267638**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
2400 Bridge Parkway	
Redwood Shores, California	**94065-1166**
(Address of principal executive offices)	**(Zip Code)**

(650) 581-2500

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or smaller reporting company. See the definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer x
Non-Accelerated filer ¨ (do not check if a smaller reporting company)	Smaller reporting company ¨

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

On March 31, 2008, 29,123,162 shares of the registrant s Common Stock, $.001 par value, were outstanding.

Table of Contents

SABA SOFTWARE, INC.

FORM 10-Q

QUARTER ENDED FEBRUARY 29, 2008

INDEX

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

SABA SOFTWARE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	February 29 2008 (Unaudited)	May 31, 2007*
ASSETS		
Current assets:		
Cash and cash equivalents	$ 14,975	$ 18,088
Restricted cash	500	500
Accounts receivable, net	23,289	20,905
Prepaid expenses and other current assets	2,774	2,767
Total current assets	41,538	42,260
Property and equipment, net	5,126	3,669
Goodwill	38,293	38,293
Purchased intangible assets, net	13,405	16,414
Other assets	1,418	977
Total assets	$ 99,780	$ 101,613
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,294	$ 4,772
Accrued compensation and related expenses	5,803	5,746
Accrued expenses	4,856	5,949
Deferred revenue	29,918	27,886
Current portion of debt and lease obligations	933	2,664
Total current liabilities	44,804	47,017
Deferred revenue	2,249	1,598
Other long term liabilities	1,347	
Accrued rent	2,623	2,769
Debt and lease obligations, less current portion	362	2,328
Total liabilities	51,385	53,712
Commitments and contingencies		
Stockholders equity:		
Preferred stock, issuable in series: $0.001 par value: 5,000,000 authorized shares at February 29, 2008 and May 31, 2007; none issued or outstanding		
Common stock, $0.001 par value: 50,000,000 authorized; 29,123,162 shares issued and outstanding at February 29, 2008 and 28,908,612 shares issued and outstanding at May 31, 2007	29	29
Additional paid-in capital	255,105	251,408

Treasury stock: 102,997 shares at February 29, 2008 and May 31, 2007, at cost	(232)	(232)
Accumulated deficit	(206,565)	(203,333)
Accumulated other comprehensive income	58	29
Total stockholders equity	48,395	47,901
Total liabilities and stockholders equity	$ 99,780	$ 101,613

* Derived from audited financial statements included in the Company s Annual Report on Form 10-K for the year ended May 31, 2007 filed with the United States Securities and Exchange Commission.

See Accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

SABA SOFTWARE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(Unaudited)

	Three months ended		Nine months ended	
	February 29, 2008	February 28, 2007	February 29, 2008	February 28, 2007
Revenues:				
License	$ 6,000	$ 4,482	$ 16,434	$ 17,586
License updates and product support	8,483	8,262	26,250	22,968
OnDemand	4,583	4,258	13,512	11,591
Professional services	8,348	7,884	23,402	22,096
Total revenues	27,414	24,886	79,598	74,241
Cost of revenues:				
Cost of license	210	207	631	983
Cost of license updates and product support	2,230	2,146	6,606	6,260
Cost of OnDemand	1,784	1,390	5,001	3,623
Cost of professional services	5,718	5,415	16,296	15,462
Amortization of acquired developed technology	295	295	883	884
Total cost of revenues	10,237	9,453	29,417	27,212
Gross profit	17,177	15,433	50,181	47,029
Operating expenses:				
Research and development	4,060	3,930	12,282	12,679
Sales and marketing	8,489	9,322	28,193	27,875
General and administrative	3,608	2,660	10,698	8,797
Amortization of purchased intangible assets	634	634	1,903	1,903
Total operating expenses	16,791	16,546	53,076	51,254
Income (loss) from operations	386	(1,113)	(2,895)	(4,225)
Interest income and other, net	112	104	370	155
Interest expense	(29)	(117)	(146)	(354)
Income (loss) before provision for income taxes	469	(1,126)	(2,671)	(4,424)
Provision for income taxes	(311)	(112)	(561)	(412)
Net income (loss)	$ 158	$ (1,238)	$ (3,232)	$ (4,836)
Basic net income (loss) per share	$ 0.01	$ (0.04)	$ (0.11)	$ (0.17)
Diluted net income (loss) per share	$ 0.01	$ (0.04)	$ (0.11)	$ (0.17)
Shares used in computing basic net income (loss) per share	29,102	28,662	29,002	28,461
Shares used in computing diluted net income (loss) per share	29,373	28,662	29,002	28,461

See Accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

SABA SOFTWARE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Nine months ended	
	February 29, 2008	February 28, 2007
Operating activities:		
Net loss	$ (3,232)	$ (4,836)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	1,358	1,087
Amortization of purchased intangible assets	3,008	3,027
Stock-based compensation expense	2,481	1,557
Loss on disposal of property and equipment	1	23
Changes in operating assets and liabilities:		
Accounts receivable	(2,110)	(317)
Prepaid expenses and other current assets	36	(98)
Other assets	(424)	168
Accounts payable	(1,518)	(2,578)
Accrued compensation and related expenses	(117)	(971)
Accrued expenses	118	(1,296)
Accrued rent	(145)	(50)
Deferred revenue	2,673	4,939
Net cash provided by operating activities	2,129	655
Investing activities:		
Purchases of property and equipment	(2,788)	(1,756)
Net cash used in investing activities	(2,788)	(1,756)
Financing activities:		
Proceeds from issuance of common stock under employee stock plans	1,215	1,308
Borrowings, under credit facility		5,193
Repayments on borrowings under credit facility	(3,623)	(5,691)
Repayments on note payable	(74)	(134)
Net cash (used in) provided by financing activities	(2,482)	676
Effect of exchange rate changes on cash	28	174
Decrease in cash and cash equivalents	(3,113)	(251)
Cash and cash equivalents, beginning of period	18,088	23,029
Cash and cash equivalents, end of period	$ 14,975	$ 22,778

See Accompanying Notes to Condensed Consolidated Financial Statements.

5

Table of Contents

SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The condensed consolidated financial statements include the accounts of Saba Software, Inc. and its wholly owned subsidiaries (Saba or the Company). All intercompany balances and transactions have been eliminated.

The accompanying condensed consolidated balance sheet as of February 29, 2008, the condensed consolidated statements of operations for the three and nine months ended February 29, 2008 and February 28, 2007 and the condensed consolidated statements of cash flows for the nine months ended February 29, 2008 and February 28, 2007 are unaudited. These unaudited interim condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles. In the opinion of management, the unaudited interim condensed consolidated financial statements include all adjustments of a normal recurring nature necessary for the fair presentation of the Company s financial position as of February 29, 2008, and the Company s results of operations for the three and nine months ended February 29, 2008 and February 28, 2007 and cash flows for the nine months ended February 29, 2008 and February 28, 2007.

These unaudited condensed consolidated financial statements should be read in conjunction with Saba s audited condensed consolidated financial statements included in Saba s Annual Report on Form 10-K filed with the Securities and Exchange Commission on August 13, 2007. The results of operations for the three and nine months ended February 29, 2008 are not necessarily indicative of results for the entire fiscal year ending May 31, 2008 or for any future period.

The condensed consolidated balance sheet at May 31, 2007 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

Certain previously reported amounts have been reclassified to conform to the current presentation. Such reclassifications did not have a significant impact on the Company s gross profit, net loss or net cash used in operating activities. Specifically, the Company has made certain reclassifications between cost of revenues and operating expense accounts.

2. Summary of Significant Accounting Policies

Revenue Recognition

Saba recognizes license revenues addressed below in accordance with the provisions of American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*. Under SOP 97-2, as amended, Saba recognizes license revenues when all of the following conditions are met:

- persuasive evidence of an arrangement exists;
- delivery has occurred;
- the fee is fixed or determinable; and
- collection is probable.

SOP 97-2, as amended, requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of the elements. Saba has analyzed each element in its multiple-element arrangements and determined that it has sufficient vendor-specific objective evidence (VSOE) to

SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

allocate revenues to certain OnDemand offerings, license updates and product support and professional services. Accordingly, assuming all other revenue recognition criteria are met, revenues from perpetual licenses are recognized upon delivery using the residual method in accordance with SOP 98-9. Saba limits its assessment of VSOE for each element to either the price charged when the same element is sold separately or the price established by management, having the relevant authority to do so, for an element not yet sold separately.

License revenue from licenses with a term of three years or more is generally recognized on delivery if the other conditions of SOP 97-2 are satisfied. Saba does not grant its resellers the right of return and does not recognize revenue from resellers until an end-user has been identified and the other conditions of SOP 97-2 are satisfied. License revenue from licenses with a term of less than three years are generally recognized ratably over the term of the arrangement. License updates and product support revenue is recognized ratably over the term of the arrangement, typically 12 months. In arrangements where term licenses are bundled with license updates and product support and such revenue is recognized ratably over the term of the arrangement, Saba allocates the revenue to license revenue and to license updates and product support revenue based on the VSOE of fair value for license updates and product support revenue on perpetual licenses of similar products.

Revenue related to professional services is generally recognized as the services are performed. Although Saba provides professional services on a time and materials basis, a portion of these services is provided on a fixed-fee basis. For services performed on a fixed fee basis, revenue is generally recognized on the proportional performance of the project, with performance measured based on hours of work performed. For contracts that involve significant customization and implementation or professional services that are essential to the functionality of the software, the license and professional services revenues are recognized over the service delivery period using the percentage-of-completion method or, if we are unable to reliably estimate the costs to complete the services, Saba uses the completed contract method of accounting in accordance with SOP 97-2 and relevant guidance of SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. A contract is considered complete when all significant costs have been incurred or the item has been accepted by the customer.

Revenue from Saba s OnDemand offerings is recognized as a service arrangement whereby the revenue is recognized ratably over the term of the arrangement or on an as-used basis if defined in the contract. Certain of its OnDemand offerings are integrated offerings pursuant to which the customers ability to access the Company s software is not separable from the services necessary to operate the software and customers are not allowed to take possession of the Company s software, in which case revenue is recognized under the SEC s Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*. Saba s OnDemand offerings also include arrangements with customers that have separately licensed and taken possession of the Company s software. When these OnDemand offerings are part of a multiple element arrangement involving licenses, Saba recognizes revenue in accordance with SOP 97-2.

In arrangements that include professional services and OnDemand offerings, but not a license of the Company s software, Saba recognizes consulting revenue for professional services as the services are performed if these professional services qualify as a separate element of the arrangement. If the professional services do not qualify as a separate element of the arrangement, the related revenues are combined with the subscription revenue and recognized ratably over the subscription service period. Additionally, Saba defers the direct costs related to the professional services and recognizes them ratably over the applicable service period. Saba categorizes deferred revenues and deferred costs on its consolidated balance sheet as current if the Company expects to recognize such revenue or cost within the following twelve months. When the revenue from professional services is recognized ratably over the subscription service period, Saba allocates the revenue to professional services revenue and to OnDemand revenue based on the VSOE of fair value for similar professional services that qualify as a separate element of the arrangement.

If the requirements of SOP 97-2 are not met when a customer pays Saba, the paid amount is recorded as deferred revenue, a liability account. As the revenue recognition principals of SOP 97-2 are satisfied, the requisite amounts are recognized as revenue.

Table of Contents

SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. Stock-Based Compensation

The Company accounts for share-based payments to employees, including grants of employee stock options and purchases under employee stock purchase plans in accordance with Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment*, which requires that these awards (to the extent they are compensatory) be recognized in the Company s consolidated statements of operations based on their fair values.

The Company currently uses the Black-Scholes-Merton option pricing model to determine the fair value of stock options and ESPP shares. The determination of the fair value of stock-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as assumptions regarding a number of complex and subjective variables. These variables include the expected term of the awards; the Company s expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends. The Company estimates the expected term of stock-based awards granted based, in part, on the Company s historical option term experience and, prior to December 31, 2007, by applying the simplified method in accordance with the SEC s SAB No. 107. The Company estimates the volatility of its common stock-based upon its historical stock price volatility over the length of the expected term of the options. The Company bases the risk-free interest rate that it uses in the option valuation model on U.S. Treasury zero-coupon issues with remaining maturities similar to the expected term of the options.

The Company does not anticipate paying any cash dividends in the foreseeable future and therefore uses an expected dividend yield of zero in the option valuation model. The Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and records stock-based compensation expense only for those awards that are expected to vest. We also consider, each quarter, whether there have been any significant changes in facts and circumstances that would affect our forfeiture rate. The expected term of employee stock purchase plan shares is the average of the remaining purchase periods under each offering period.

The following assumptions have been used to value the awards granted during the three and nine months ended February 29, 2008 and February 28, 2007 under the Company s stock option plans and stock purchased under the ESPP:

	Three months ended		Nine months ended	
	February 29, 2008	February 28, 2007	February 29, 2008	February 28, 2007
Stock Options:				
Expected volatility	46%	58.3%	47.5%	62.4%
Risk-free interest rates	1.7%	4.5%	3%	4.6%
Expected term (years)	2.6	4.1	3.6	4.1
Expected dividend yield	0%	0%	0%	0%
Employee Sock Purchase Plan:				
Expected volatility	45%	44%	45%	47%
Risk-free interest rates	3.3%	5.0%	4.1%	5.1%
Expected term (years)	0.5 2.0	0.5 2.0	0.5 2.0	0.5 2.0
Expected dividend yield	0%	0%	0%	0%

The following table summarizes the stock-based compensation expense for stock options and ESPP shares that was recorded in the Company s results of operations in accordance with SFAS 123R for the three and nine months ended February 29, 2008 and February 28, 2007.

SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

	Three months ended		Nine months ended	
(in thousands)	**February 29, 2008**	**February 28, 2007**	**February 29, 2008**	**February 28, 2007**
Cost of revenues	$ 94	$ 74	$ 306	$ 188
Research and development	105	107	370	278
Sales and marketing	204	213	761	631
General and administrative	154	156	1,044	460
Stock-based compensation expense included in net income /(loss)	$ 557	$ 550	$ 2,481	$ 1,557

Included in the stock-based compensation expense allocated to general and administrative expense for the nine months ended February 29, 2008 was a non-cash charge of $632,000 during the three months ended August 31, 2007, related to an employment agreement amendment which modified the events that trigger accelerated vesting of options and allowed for an extension to standard exercise terms. The modification of terms created incremental compensation costs when remeasured based on the then current circumstances. Those current assumptions ranged as follows: expected volatility of 42% to 49%; risk free interest rates of 4.9% to 5.0%; and expected term (years) of 0.75 to 3.5.

During the three months ended August 31, 2007, the Company s Board of Directors approved an increase to the Company s 2000 Stock Incentive Plan by approximately 1.4 million shares.

4. Basic and Diluted Net Income (Loss) Per Share

Basic and diluted net income (loss) per share information for all periods is presented under the requirements of SFAS No. 128, *Earnings per Share*. Basic earnings per share have been computed using the weighted-average number of shares of common stock outstanding during the period. Basic earnings per share excludes the dilutive effects of options as well as any contingently issuable shares in escrow for which specific conditions have not yet been met. Potentially dilutive issuances have been excluded from the computation of diluted net income (loss) per share as their inclusion would be anti-dilutive. The calculations of basic and diluted net income (loss) per share are as follows:

	Three months ended		Nine months ended	
(in thousands, except per share data)	**February 29, 2008**	**February 28, 2007**	**February 29, 2008**	**February 28, 2007**
Net income (loss)	$ 158	$ (1,238)	$ (3,232)	$ (4,836)
Weighted-average shares of common stock outstanding used in computing diluted net income (loss) per share	29,102	28,662	29,002	28,461
Effect of dilutive employee stock options	271			
Weighted-average shares of common stock used in computing diluted net income (loss) per share	29,373	28,662	29,002	28,461
Basic net income (loss) per share	$ 0.01	$ (0.04)	$ (0.11)	$ (0.17)
Diluted net income (loss) per share	$ 0.01	$ (0.04)	$ (0.11)	$ (0.17)

For the three months ended February 29, 2008 and February 28, 2007, 4.1 million and 1.4 million weighted-average potential common shares, respectively, and for the nine months ended February 29, 2008 and February 28, 2007, 3.7 million and 2.0 million weighted-average potential common shares, respectively, consisting of outstanding stock options and shares related to the THINQ Learning Solutions, Inc. (THINQ) acquisition, are excluded from the determination of diluted net income (loss) per share, as the effect of such shares is anti-dilutive.

SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. Comprehensive Income (Loss)

Saba reports comprehensive loss in accordance with SFAS No. 130, *Reporting Comprehensive Income*. The following table sets forth the calculation of comprehensive loss for all periods presented:

(in thousands)	Three months ended February 29, 2008	Three months ended February 28, 2007	Nine months ended February 29, 2008	Nine months ended February 28, 2007
Net income (loss)	$ 158	$ (1,238)	$ (3,232)	$ (4,836)
Foreign currency translation (loss) gain	(2)	56	28	252
Comprehensive income (loss)	$ 156	$ (1,182)	$ (3,204)	$ (4,584)

6. Goodwill and Purchased Intangible Assets

Purchased intangible assets consist of acquired developed technology, customer relationships and backlog and tradenames acquired as part of a purchase business combination. The intangible assets are stated at cost less accumulated amortization and are being amortized on a straight-line basis over their estimated useful lives of three to seven years.

There were no additions to intangible assets during the three and nine months ended February 29, 2008. The following tables provide a summary of the carrying amounts of purchased intangible assets that continue to be amortized:

	February 29, 2008			
(in thousands)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Useful Life
Customer backlog	$ 740	$ (722)	$ 17	2.4 Years
Customer relationships	14,920	(5,447)	9,473	6.3 Years
Tradenames	820	(342)	478	5 Years
Acquired developed technology	5,890	(2,454)	3,436	5 Years
Total	$ 22,370	$ (8,965)	$ 13,405	

	May 31, 2007			
(in thousands)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Useful Life
Customer backlog	$ 740	$ (500)	$ 240	2.4 Years

Customer relationships	14,920	(3,666)	11,254	6.3 Years
Tradenames	820	(219)	601	5 Years
Acquired developed technology	5,890	(1,571)	4,319	5 Years
Total	$ 22,370	$ (5,956)	$ 16,414	

The total expected future amortization related to purchased intangible assets will be approximately $947,000, for the remainder of fiscal 2008 and $3,716,000, $3,716,000, $3,268,000 and $1,759,000 in fiscal years 2009 through 2012, respectively. There is no future amortization expected after fiscal 2012 with respect to these purchased intangible assets.

Goodwill is reviewed annually for impairment (or more frequently if indicators of impairment arise or circumstances otherwise dictate). The Company completed its annual impairment assessment in fiscal 2007 and concluded that goodwill was not impaired. Through the nine month period ended February 29, 2008, there were no indicators of impairment of goodwill and intangible assets. The Company will complete its annual impairment assessment for fiscal year 2008 in the fourth quarter.

Table of Contents

SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

There were no changes to the carrying amount of goodwill for the three and nine months ended February 29, 2008.

7. Debt and Other Obligations

Credit Facility

Since August 2002, Saba has maintained a credit facility with a bank. On January 31, 2006, the Company entered into a new credit facility with the bank. The credit facility replaced the Company s existing credit facility with the bank. The credit facility provides for (i) a term loan in a principal amount of $6,500,000, and (ii) a receivables borrowing base revolving credit line in an aggregate principal amount of up to $7,500,000 at any time outstanding, which includes a sub-limit of up to $5,000,000 for letters of credit, cash management and foreign exchange services. In November 2006, the Company amended the credit facility to add an equipment facility up to a principal amount of $3,000,000. Both the term loan and the equipment facility are required to be repaid in 36 equal monthly installments of principal, plus interest. The equipment facility s term begins with the date of each advance under the contract. The Company obtained advances on November 30, 2006 and February 28, 2007. The maturity date of the term loan and the revolving credit line is January 31, 2009. The interest rate applicable to the loans under the credit facility is the bank s prime rate plus 0.50% for the term loan and the bank s prime rate plus 0.25% for borrowings under the revolving credit line and the equipment facility. The Company is required to pay an early termination fee if the credit facility is terminated by the bank due to the occurrence of an event of default or is refinanced by another financial institution, in each case, prior to the second anniversary of the credit facility. As of February 29, 2008 and May 31, 2007, the Company had borrowings on the term loan of $467,000 and $3.8 million, respectively, and outstanding obligations of $729,000 and $1.0 million, respectively, on the equipment facility. As of February 29, 2008, there were no borrowings and $7.4 million was available under the accounts receivable borrowing base portion of the revolving credit line.

The credit facility is secured by all of the Company s personal property other than its intellectual property. The credit facility includes certain negative covenants restricting or limiting the ability of the Company and its subsidiaries to, among other things: encumber its intellectual property; incur additional indebtedness; create liens on its property; make certain investments and acquisitions; merge or consolidate with any other entity; convey, sell, lease, transfer or otherwise dispose of assets; change its business; experience a change of control; pay dividends, distributions or make other specified restricted payments; and enter into certain transactions with affiliates. Such restrictions and limitations are subject to usual and customary exceptions contained in credit agreements of this nature. In addition, the credit facility requires the Company to satisfy a minimum consolidated EBITDA covenant on a quarterly basis and a minimum liquidity covenant on a monthly basis. EBITDA, or earnings before income tax, depreciation and amortization, also excludes stock-based compensation and includes the estimated revenue that would have been recorded related to the Centra deferred revenue fair value adjustment. As of May 31, 2007, the Company was in compliance with the liquidity covenant, but not in compliance with the EBITDA covenant. During the quarter ended August 31, 2007, the Company and the bank entered into a waiver and amendment to the loan agreement providing for (i) a waiver of the Company s non-compliance with the EBITDA covenant at May 31, 2007 and (ii) a reduced EBITDA covenant for the quarter ending August 31, 2007. As of February 29, 2008, the Company was in compliance with the liquidity and EBITDA covenants. If the Company violates any of these amended restrictive covenants or otherwise breaches the credit facility agreement, the Company may be required to repay the obligations under the credit facility prior to their stated maturity date, the Company s ability to borrow under the revolving credit line may be terminated and the bank may be able to foreclose on any collateral provided by the Company. Any of these events, were they to occur, would likely have a material and adverse effect on the Company s business, financial condition and results of operations.

SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. Restructuring

During fiscal 2006, as part of the acquisition of Centra Software, Inc. (Centra), management approved and initiated a plan to restructure and eliminate duplicative pre-merger activities and reduce the Company s cost structure (the Centra Restructuring). Total restructuring costs associated with exiting activities were estimated to be approximately $2.4 million. The components of accrued restructuring charges and movements within these components through February 29, 2008 for the Centra Restructuring were as follows:

(in thousands)	Workforce Reduction Charges	Facilities Related Charges	Total
Accrual as of May 31, 2006	$ 927	$ 593	$ 1,520
Adjustments	(32)	314	282
Deductions cash payments	(803)	(553)	(1,356)
Accrual as of May 31, 2007	92	354	446
Deductions cash payments	(92)	(240)	(332)
Accrual as of February 29, 2008	$	$ 114	$ 114

During fiscal 2006, Saba implemented a restructuring program (the 2006 Restructuring) to consolidate excess facilities as a result of its acquisitions of THINQ and Centra. The restructuring program was implemented under the provisions of SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*.

During 2006, the facilities restructuring charge of $358,000, which was recorded as part of the Company s general and administrative expense in the consolidated statement of operations, was based on the present value of the sum of non-cancelable lease costs, less estimates for future sublease income. In February 2007, the Company amended its remaining lease for these facilities and relinquished all rights in the excess facility. As no further payments were due related to this excess facility, the Company reduced its general and administrative expenses by the amount of the remaining portion of the restructuring accrual of $211,000.

9. Guarantees

Saba enters into license agreements that generally provide indemnification for its customers against intellectual property claims. To date, Saba has not incurred any costs as a result of such indemnifications and has not accrued any liabilities related to such obligations in its consolidated financial statements.

Saba s license agreements also generally include a warranty that its software products will substantially operate as described in the applicable program documentation for a period of generally 90 days after delivery. To date, Saba has not incurred or accrued any material costs associated with these warranties.

10. Income Taxes

From inception through February 29, 2008, the Company has incurred net losses for federal and state tax purposes. Income tax expense for the three and nine months ended February 29, 2008 was $311,000 and $561,000, respectively, and $112,000 and $412,000 during the three and nine months ended February 28, 2007. Income tax expense during both of these periods consists primarily of foreign tax expense incurred as a result of local country profits and tax contingencies.

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with

SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

SFAS No. 109, *Accounting for Income Taxes*. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure and transition.

The Company adopted FIN 48 effective June 1, 2007. As a result of the implementation of FIN 48, the Company did not recognize a cumulative adjustment to the June 1, 2007 balance of retained earnings.

As of June 1, 2007, the Company had unrecognized tax benefits of approximately $7.4 million, which did not change significantly during the nine months ended February 29, 2008. The unrecognized tax benefits are exclusive of accrued interest and penalties. Included in the balance of unrecognized tax benefits as of June 1, 2007, is approximately $761,000, inclusive of interest and penalties, of tax benefits that, if recognized, would result in an adjustment to our effective tax rate. The amount of unrecognized tax benefits that would result in an adjustment to goodwill is $637,000.

The Company anticipates an increase to the unrecognized tax benefits during the year ending May 31, 2008, as compared to the year ended May 31, 2007, of approximately $184,000. The anticipated increase will be due primarily to the accrual of additional reserves and interest accrued on existing reserves. The Company has historically classified accruals for tax uncertainties in current taxes payable and, where appropriate, as a reduction to deferred tax assets. As a result of the adoption of FIN 48, the Company has reclassified $1.3 million from current taxes payable to other long-term liabilities.

In accordance with FIN 48, paragraph 19, the Company classifies interest and penalties related to uncertain tax positions as a component of its provision for income taxes. Accrued interest and penalties relating to the income tax on the unrecognized tax benefits as of June 1, 2007, was approximately $588,000.

During the third quarter of fiscal year 2008, the unrecognized tax benefit increased by $54,000. The increase is mainly the result of the Company s continuing effort to reserve for tax contingencies.

Due to the Company s taxable loss position since inception, all tax years are subject to examination in U.S. federal and state jurisdictions. The Company is also subject to examination in various foreign jurisdictions for tax years 1996 forward, for which the Company believes it has established adequate reserves.

As of February 29, 2008 and May 31, 2007, the Company has established a valuation allowance against the full amount of any net deferred tax assets. The Company currently provides a valuation allowance against deferred tax assets when it is more likely than not that some portion, or all of its deferred tax assets, will not be realized.

11. Segment Information

Saba operates in a single operating segment, providing software and services that drive organizational excellence by bringing a disciplined approach to aligning, developing, and managing people across the entire organization.

12. Litigation

Litigation Relating to Initial Public Offering of Saba

In November 2001, a complaint was filed in the United States District Court for the Southern District of New York (the District Court) against the Company, certain of its officers and directors, and certain underwriters of its initial public offering. The complaint was purportedly filed on behalf of a class of certain persons who purchased the Company s common stock between April 6, 2000 and December 6, 2000. The complaint alleges violations by the Company and its officers and directors of Section 11 of the Securities Act of 1933, as amended (the Securities

SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Act), Section 10(b) of the Securities Exchange Act of 1934, as amended (the Exchange Act), and other related provisions in connection with certain alleged compensation arrangements entered into by the underwriters in connection with the offering. An amended complaint was filed in April 2002. Similar complaints have been filed against hundreds of other issuers that have had initial public offerings since 1998. The complaints allege that the prospectus and the registration statement for the offering failed to disclose that the underwriters allegedly solicited and received excessive commissions from investors and that some investors in the IPO offering agreed with the underwriters to buy additional shares in the aftermarket in order to inflate the price of the Company s stock. The complaints were later consolidated into a single action. The complaint seeks unspecified damages, attorney and expert fees, and other unspecified litigation costs.

On July 1, 2002, the underwriter defendants in the consolidated actions moved to dismiss all of the actions, including the action involving the Company. On July 15, 2002, the Company, along with other non-underwriter defendants in the coordinated cases, moved to dismiss the litigation. On February 19, 2003, the District Court ruled on the motions. The District Court granted the Company s motion to dismiss the claims against it under Rule 10b-5, due to the insufficiency of the allegations against the Company. The District Court also granted the motion of the individual defendants, Bobby Yazdani and Terry Carlitz, the Company s Chief Executive Officer and Chairman of the Board and former Chief Financial Officer and a member of the Company s board of directors, to dismiss the claims against them under Rule 10b-5 and Section 20 of the Exchange Act. The motions to dismiss the claims under Section 11 of the Securities Act were denied as to virtually all of the defendants in the consolidated cases, including the Company.

In June 2004, an agreement of partial settlement was submitted to the District Court for preliminary approval. The District Court granted the preliminary approval motion on February 15, 2005, subject to certain modifications. On August 31, 2005 the District Court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. The District Court also appointed the notice administrator for the settlement and ordered that notice of the settlement be distributed to all settlement class members by January 15, 2006. The settlement fairness hearing occurred on April 24, 2006, and the court reserved decision at that time.

While the partial settlement was pending approval, the plaintiffs continued to litigate against the underwriter defendants. The District Court directed that the litigation proceed within a number of focus cases rather than in all of the 310 cases that have been consolidated. Centra s case is not one of these focus cases. On October 13, 2004, the District Court certified the focus cases as class actions. The underwriter defendants appealed that ruling, and on December 5, 2006, the Court of Appeals for the Second Circuit reversed the District Court s class certification decision. On April 6, 2007, the Second Circuit denied plaintiffs petition for rehearing. In light of the Second Circuit opinion, counsel for the issuer defendants informed the District Court that this settlement cannot be approved because the defined settlement class, like the litigation class, cannot be certified. On June 25, 2007, the District Court entered an order terminating the settlement agreement. On August 14, 2007, the plaintiffs filed their second consolidated amended class action complaints against the focus cases and on September 27, 2007, again moved for class certification. On November 12, 2007, certain of the defendants in the focus cases moved to dismiss the second consolidated amended class action complaints. On March 26, 2008, the District Court denied the motions to dismiss except as to Section 11 claims raised by those plaintiffs who sold their securities for a price in excess of the initial offering price and those who purchased outside the previously certified class period. Briefing on the class certification motion is scheduled to be completed in April 2008.

The Company intends to dispute these claims and defend the law suit vigorously. However, due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the litigation. An unfavorable outcome in litigation could materially and adversely affect the Company s business, financial condition and results of operations.

Litigation Relating to Initial Public Offering of Centra

Centra, certain of its former officers and directors and the managing underwriters of Centra s initial public offering were named as defendants in an action filed in the District Court. The plaintiffs filed an initial complaint on December 6, 2001 and purported to serve the Centra defendants on or about March 18, 2002. The original

14

Table of Contents

SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

complaint has been superseded by an amended complaint filed in April 2002. The action, captioned in re Centra Software, Inc. Initial Public Offering Securities Litigation, No. 01 CV 10988, which is being coordinated with an action captioned in re Initial Public Offering Securities Litigation, No. 21 MC 92, is purportedly brought on behalf of the class of persons who purchased Centra s common stock between February 3, 2000 and December 6, 2000. The complaint asserts claims under Sections 11 and 15 of the Securities Act and Sections 10(b) and 20(a) of the Exchange Act. The complaint alleges that, in connection with Centra s initial public offering in February 2000, the underwriters received undisclosed commissions from certain investors in exchange for allocating shares to them and also agreed to allocate shares to certain customers in exchange for the agreement of those customers to purchase additional shares in the aftermarket at pre-determined prices. The complaint asserts that Centra s registration statement and prospectus for the offering were materially false and misleading due to their failure to disclose these alleged arrangements. The complaint seeks damages in an unspecified amount against Centra and the named individuals. The underwriter defendants and the Centra defendants joined in motions to dismiss the above-referenced action on July 3 and July 15, 2002, respectively. On October 9, 2002, the plaintiffs dismissed, without prejudice, the claims against the named Centra officers and directors in the above-referenced action. On February 19, 2003, the District Court issued an order denying the motion to dismiss as to Centra and other defendants. In June 2004, an agreement of settlement was submitted to the Court for preliminary approval. The District Court granted the preliminary approval motion on February 15, 2005, subject to certain modifications. On August 31, 2005 the District Court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. The District Court also appointed the notice administrator for the settlement and ordered that notice of the settlement be distributed to all settlement class members by January 15, 2006. The settlement fairness hearing occurred on April 24, 2006, and the court reserved decision at that time.

While the partial settlement was pending approval, the plaintiffs continued to litigate against the underwriter defendants. The District Court directed that the litigation proceed within a number of focus cases rather than in all of the 310 cases that have been consolidated. The Company s case is not one of these focus cases. On October 13, 2004, the District Court certified the focus cases as class actions. The underwriter defendants appealed that ruling, and on December 5, 2006, the Court of Appeals for the Second Circuit reversed the District Court s class certification decision. On April 6, 2007, the Second Circuit denied plaintiffs petition for rehearing. In light of the Second Circuit opinion, counsel for the issuer defendants informed the District Court that this settlement cannot be approved because the defined settlement class, like the litigation class, cannot be certified. On June 25, 2007, the District Court entered an order terminating the settlement agreement. On August 14, 2007, the plaintiffs filed their second consolidated amended class action complaints against the focus cases and on September 27, 2007, again moved for class certification. On November 12, 2007, certain of the defendants in the focus cases moved to dismiss the second consolidated amended class action complaints. On March 26, 2008, the District Court denied the motions to dismiss except as to Section 11 claims raised by those plaintiffs who sold their securities for a price in excess of the initial offering price and those who purchased outside the previously certified class period. Briefing on the class certification motion is scheduled to be completed in April 2008.

On December 28, 2007, the underwriter defendants moved to strike class allegations in 26 cases, including Centra s, in which the plaintiffs failed to identify proposed class representatives, and the issuer defendants joined in the motion. Briefing on the motion was completed in February 2008.

The Company, on behalf of Centra, intends to dispute these claims and defend the law suit vigorously. However, due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the litigation. An unfavorable outcome in litigation could materially and adversely affect the Company s business, financial condition and results of operations.

Two individuals in Colorado have excluded themselves from the class action settlement and have each filed individual actions in state court in Colorado. These same individuals have filed similar actions against other issuers and their officers. The actions assert violations of Sections 10(b) and 20(a) of the Exchange Act, as well as common law fraud and intentional infliction of emotional distress. The complaints each seek compensation for a drop in stock price from the time of the plaintiffs purchase to the time of their sale and for alleged emotional distress. Centra prevailed on a motion to dismiss the complaints. The two individuals appealed the ruling and the appeal has been briefed by the parties.

SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The Company, on behalf of Centra intends to defend the law suit vigorously. However, due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the litigation. An unfavorable outcome of the litigation could materially and adversely affect the Company s business, financial condition and results of operations.

Litigation Relating to Claim of Patent Infringement by Centra

On August 19, 2003, a complaint was filed against Centra and two other defendants by EdiSync Systems, LLC, in the United States District Court for the District of Colorado (No. 03-D-1587 (OES)) (the Colorado District Court). The complaint alleges infringement of two patents for a remote multiple user editing system and method and seeks permanent injunctive relief against continuing infringement, compensatory damages in an unspecified amount, and interest, costs and expenses associated with the litigation. Centra has filed an answer to the complaint denying all of the allegations. No amount has been accrued related to this matter and legal costs incurred in the defense of the matter are being expensed as incurred. Centra filed a request for reexamination of the patents at issue with the U.S. Patent and Trademark Office (the Patent Office). The Company s patent counsel is of the opinion that claims of the patents involved in the suit are invalid. The re-examination request was accepted by the Patent Office and the Colorado District Court has approved the parties motion to stay the court proceedings during the re-examination proceedings. A reexamination certificate has issued for one of the patents that canceled all of the patent s claims, thus rendering that patent of no further force or effect. A final office action has issued in the other reexamination proceeding in which all of the patent s original claims were rejected but a handful of newly-added claims were indicated as being allowable. The Company believes that it has meritorious defenses with respect to the other patent and intends to vigorously defend this action. However, due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the litigation. An unfavorable outcome of the litigation could materially and adversely affect the Company s business, financial condition and results of operations.

Litigation Relating to Claim of Patent Infringement by Saba

On November 19, 2007, a complaint was filed against the Company and ten other defendants by Gemini IP, LLC, in the United States District Court for the Eastern District of Texas (No. 07-CV-521). The complaint alleges infringement of a patent directed to a method for processing client help requests using a computer network and seeks permanent injunctive relief against continuing infringement, compensatory damages in an unspecified amount, and interest, costs and expenses associated with the litigation. The Company has filed an answer to the complaint denying all of the allegations. On February 27, 2008, the Company filed a request for reexamination of the asserted patent with Patent Office and is awaiting a decision from the Patent Office on that request. On March 17, 2008, the Company filed a motion with the District Court asking it to stay the litigation pending completion of the reexamination proceedings. The Court has not yet ruled on that motion. The Company believes that it has meritorious defenses with respect to the asserted patent and intends to vigorously defend this action. However, due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the litigation. An unfavorable outcome of the litigation could materially and adversely affect the Company s business, financial condition and results of operations.

Other Litigation

The Company is also party to various legal disputes and proceedings arising from the ordinary course of general business activities. While, in the opinion of management, resolution of these matters is not expected to have a material adverse effect on the Company s consolidated financial position, results of operations or cash flows, the ultimate outcome of any litigation is uncertain. Were an unfavorable outcome to occur, the impact could be material to the Company.

Table of Contents

SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

13. Recent Accounting Pronouncements

In June 2006, the FASB issued FIN 48, which clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with SFAS No. 109 and prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Additionally, FIN 48 provides guidance on derecognition of tax positions, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company adopted FIN 48 as of June 1, 2007, and no adjustment to retained earnings was required.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company will be required to adopt SFAS No. 157 in the first quarter of fiscal year 2009. The Company is currently evaluating the requirements of SFAS No. 157 and has not yet determined the impact on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 allows entities to voluntarily choose, at specified election dates, to measure certain financial assets and financial liabilities (as well as certain non-financial instruments that are similar to financial instruments) at fair value (the fair value option). The election is made on an instrument-by-instrument basis and is irrevocable. If the fair value option is elected for an instrument, SFAS No. 159 specifies that all subsequent changes in fair value for that instrument shall be reported in earnings. SFAS No. 159 is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007. The Company is currently evaluating the effect that SFAS No. 159 will have on its consolidated financial statements, should the Company decide to adopt its provisions. Should the Company decide to adopt SFAS No. 159, it will do so in the first quarter of fiscal year 2009.

In June 2007, the FASB ratified EITF 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities*. EITF 07-3 requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and capitalized and recognized as an expense as the goods are delivered or the related services are performed. EITF 07-3 is effective, on a prospective basis, for fiscal years beginning after December 15, 2007. The Company will be required to adopt EITF 07-3 in the first quarter of fiscal year 2009. The Company is currently evaluating the requirements of EITF 07-3 and has not yet determined the impact on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised) (SFAS No. 141(R)), *Business Combinations*. SFAS No. 141(R) changes the accounting for business combinations including the measurement of acquirer shares issued in consideration for a business combination, the recognition of contingent consideration, the accounting for preacquisition gain and loss contingencies, the recognition of capitalized in-process research and development, the accounting for acquisition-related restructuring cost accruals, the treatment of acquisition related transaction costs and the recognition of changes in the acquirer s income tax valuation allowance. SFAS No. 141(R) is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. The Company will be required to adopt SFAS No. 141(R) in the first quarter of fiscal year 2010.

14. Related Party Transactions

The Executive Vice President of Varian Medical Systems, Inc. (Varian) and the Chairman and Chief Executive Officer of Masimo Corporation (Masimo) serve as directors on Saba s Board of Directors. For the three and nine months ended February 29, 2008, Saba licensed its software and sold related support and services to Varian in the aggregate amounts of $47,000 and $216,000 and to Masimo in the aggregate amounts of $61,000 and $102,000, respectively. At February 29, 2008, Saba s accounts receivable included $108,000 due from Varian and $76,000 due from Masimo. At May 31, 2007, Saba s accounts receivable included $287,000 due from Varian and no amounts due from Masimo.

Table of Contents

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the consolidated financial statements and related notes contained herein and the information included in our other filings with the Securities and Exchange Commission. This discussion includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). All statements in this Quarterly Report on Form 10-Q other than statements of historical fact are forward-looking statements. These forward-looking statements involve known and unknown risks and uncertainties. Our actual results may differ materially from those projected or assumed in such forward-looking statements. Among the factors that could cause actual results to differ materially are the factors detailed under Part II, Item 1A: Risk Factors of this Quarterly Report on Form 10-Q. All forward-looking statements and risk factors included in this document are made as of the date of this report, based on information available to us as of such date. We assume no obligation to update any forward-looking statement or risk factor.

Forward-looking statements include statements regarding:

(i) in Part I, Item 1,

- *future amortization related to intangible assets,*
- *our anticipation that we will not pay any cash dividends in the foreseeable future,*
- *the resolution and effect of pending litigation,*
- *the effect of recent accounting changes,*
- *anticipated increase in unrecognized tax benefits,*
- *estimated restructuring costs,*
- *our beliefs regarding the adequacy of our reserves for foreign tax examinations,*

(ii) in Part I, Item 2,

- *our belief that the acquisition of Centra strengthened our competitive position and provided us with a broader and deeper product offering,*
- *our expectation that the Saba Enterprise Suite and Saba Centra product suite will generate substantially all of our license revenues for the foreseeable future,*
- *our belief that OnDemand revenue will continue to grow for the foreseeable future,*

our belief that license updates and product support revenue will continue to grow for the foreseeable future due to our expanded customer base,

our anticipation that a substantial majority of our customers will renew their annual contracts and the sale of new licenses will increase the number of customers that purchase license updates and product support,

our expectations regarding future levels of research and development expenses,

our expectations relating to future amortization expenses,

our estimate regarding our levels of unrecognized tax benefits within the next 12 months,

our anticipation that we will continue to experience long sales cycles,

our anticipation that our available cash resources and credit facilities, combined with cash flows generated from revenues, will be sufficient to meet our presently anticipated working capital, capital expense and business expansion requirements, for at least the next 12 months,

our expectations regarding future levels of sales and marketing expenses,

our anticipation that we will not pay any cash dividends in the foreseeable future,

our expectations regarding our gross margin for license updates and product support for the foreseeable future,

our intent to invest additional resources in OnDemand infrastructure and our expectation regarding gross margin as OnDemand revenue increases,

our belief that the cost of professional services will increase;

(iii) in Part II, Item 1,

the resolution and effect of pending litigation,

Table of Contents

(iv) in Part II, Item 1A,

our expectation that we will derive substantially all of our revenues for the foreseeable future from the licensing of the Saba Enterprise Suite and the Saba Centra product suite and providing related services,

our expectation to continue to incur non-cash expenses relating to the amortization of purchased intangible assets along with any potential goodwill impairment,

our expectation that our operating results will fluctuate significantly in the future,

our success depending on our ability to attract and retain additional personnel,

our expectation that competition and the pace of change will increase in the future,

our intention to expand our international presence in the future,

our expectation to continue to acquire complementary businesses or technologies,

our expectation to regularly release new products and new versions of our existing products,

our belief regarding the Edisync Systems litigation,

our belief that our success depends on our proprietary technology, and

our belief that our success depends on the acceptance and successful integration by customers of our products.

These forward-looking statements involve known and unknown risks and uncertainties. Our actual results may differ materially from those projected or assumed in such forward-looking statements. Among the factors that could cause actual results to differ materially are:

defects and other problems with our products,

unanticipated adverse changes in the international markets,

incorrect estimates or assumptions,

unanticipated adverse results for pending litigation,

contraction of the economy and world markets,

lack of demand for information technologies from our customers,

requirements for increased spending in research and development,

unanticipated need for capital for operations,

lack of demand for our products,

inability to introduce new products, and

the factors detailed under Part II, Item 1A: Risk Factors of this Quarterly Report on Form 10-Q.

OVERVIEW

General

We help organizations manage their most important asset their people. We provide the premier software platform for enterprise learning, collaboration, performance, and talent management, as well as license updates and product support, and OnDemand, implementation, training, and consulting services. Our people management solutions drive organizational excellence by bringing a disciplined approach to aligning, developing, and managing people across the entire organization.

By using Saba to manage their extended workforce, our customers achieve demonstrably higher levels of performance through:

Increased productivity, sales and service effectiveness

Reduced personnel development and training costs

Improved organizational agility and execution

Our solutions help our customers through the implementation of a management system for aligning goals, developing and motivating people and measuring results. By implementing our solutions, organizations are better equipped to: align their workforce around the organization s business objectives; effectively manage growing regulatory requirements; increase sales and channel readiness; accelerate the productivity of new people joining the extended enterprise of employees, customers, partners, and suppliers; increase both the speed of customer acquisition and long-term customer loyalty; shorten time-to-market of new products; and improve visibility into organizational performance.

Background

We commenced operations in April 1997 and, through March 1998, focused substantially all of our efforts on research activities, developing our products and building our business infrastructure. We shipped our first Saba Enterprise Learning products and began to generate revenues from software license fees, implementation and consulting services fees and support fees in April 1998.

On May 5, 2005, we completed the acquisition of THINQ Learning Solutions, Inc. (THINQ), a provider of enterprise learning management solutions which allowed us to expand our customer base and provided greater scale to increase our investment in research and development to accelerate innovation and increase stockholder value.

On January 31, 2006, we completed the acquisition of Centra Software, Inc. (Centra), a provider of online learning and training software and services. We believe our acquisition of Centra strengthened our competitive position in the human capital management market and provided us with a broader and deeper product offering. In addition, as a result of the acquisition our customer base substantially increased. The Centra acquisition included total purchase consideration of $62.3 million

Our corporate headquarters are located in Redwood Shores, California. We have an international presence in India, France, Japan, Germany, the United Kingdom, Canada and Australia through which we conduct various operating activities related to our business. In each of the non-U.S. jurisdictions in which we have subsidiaries, other than India, we have employees or consultants engaged in sales and services activities. In the case of our India subsidiary, our employees primarily engage in software development and quality assurance testing activities.

Sources of Revenue

We generate revenues from the sale of software licenses, OnDemand services, annual license updates and product support, and professional services.

Software Licenses

We license our software solutions in multi-element arrangements that include a combination of our software, license updates and product support and/or professional services. A significant amount of our license sales are for perpetual licenses. To date, a substantial majority of our software license revenue has been derived from the Saba Learning product suite. For the foreseeable future, we expect the Saba Enterprise Suite and Saba Centra product suite to generate substantially all of our software license revenue. Our license revenue is affected by the strength of general economic and business conditions, as well as customers budgetary cycles and the competitive position of our software products. In addition, the sales cycle for our products is long, typically six to twelve months. The timing of a few large software license transactions can substantially affect our quarterly license revenue.

OnDemand

OnDemand revenue includes revenue derived from term-based managed application services. These services are provided pursuant to customer agreements with terms typically ranging from one to three years. The associated OnDemand revenue is recognized ratably over the term of the agreement. We believe that OnDemand revenue will continue to grow for the foreseeable future as we anticipate that a substantial majority of our customers will renew their contracts on expiration and that we will continue to add new OnDemand customers.

Licenses Updates and Product Support

License updates and product support includes the right to receive future unspecified updates for the applicable software product and technical support. We typically sell license updates and product support for an initial period of one year concurrently with the sale of the related software license. After the initial period, license updates and product support is renewable on an annual basis at the option of the customer. Our license updates and product support revenue depends upon both our sales of additional software licenses and annual renewals of existing license

Table of Contents

updates and product support agreements. We believe that license updates and product support revenue will grow steadily for the foreseeable future as we anticipate that a substantial majority of our customers will renew their annual contracts and the sale of new software licenses will increase the number of customers that purchase license updates and product support.

Professional Services

Our professional services business consists of consulting, education and strategic services. Consulting and education services are typically provided to customers that license software directly from us. These consulting and education services are generally provided over a period of three to nine months after licensing the software. Generally, consulting services related to software implementation are not considered essential to the functionality of the software. Our consulting and education services revenue varies directly with the levels of license revenue generated from our direct sales organization in the preceding three to nine month period. In addition, our consulting and education services revenue varies following our commercial release of significant software updates as our customers generally engage our services to assist with the implementation of their software update. Although we provide consulting services on a time and materials basis, a portion of these services is provided on a fixed fee basis. Strategic services are less dependent than consulting and education services on the sale of our licenses. Strategic services present additional opportunities that arise at different times throughout a customer life cycle.

Cost of Revenue

Our cost of revenue primarily consists of compensation, employee benefits and out-of-pocket travel-related expenses for our employees, including our OnDemand and license update and product support personnel, and the fees of third-party subcontractors, who provide professional services to our clients. Additionally, costs of revenue also includes external hosting fees and depreciation and amortization charges on the necessary OnDemand infrastructure, third-party license royalty costs, and overhead allocated based on headcount and reimbursed expenses. The amortization of acquired developed technology, comprised of the ratable amortization of technological assets acquired in the acquisition of Centra in 2006, is also included in the cost of revenue. Many factors affect our cost of revenue, including changes in the mix of products and services, pricing trends and changes in the amount of reimbursed expenses. Because cost as a percentage of revenues is higher for services than for software licenses, an increase in services, including OnDemand services, as a percentage of our total revenue would reduce gross profit as a percentage of total revenue.

Operating Expenses

We classify all operating expenses, except amortization of purchased intangible assets and in-process research and development, to the research and development, sales and marketing, and general and administrative expense categories based on the nature of the expenses. Each of these three categories includes commonly recurring expenses such as salaries (including stock-based compensation), employee benefits, travel and entertainment costs, and allocated communication, rent and depreciation costs. We allocate communication, rent and depreciation costs to each of the functional areas that derive a benefit from such costs based upon their respective headcounts. The sales and marketing category of operating expenses also includes sales commissions and expenses related to public relations and advertising, trade shows and marketing collateral materials. The general and administrative category of operating expenses also includes allowances for doubtful accounts and administrative and professional services fees.

CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ materially from those estimates. We base our estimates and judgments on historical experience and on various other assumptions that we believe are reasonable under the circumstances. However, future events are subject to change and the best estimates and judgments routinely require adjustment. While a number of accounting policies, methods and estimates affect our financial statements, areas that are particularly significant include revenue recognition policies, the allowance for doubtful accounts, the assessment of recoverability of goodwill and purchased intangible assets and restructuring costs. We have reviewed the critical accounting policies described in the following paragraphs with the Audit Committee of our Board of Directors.

Revenue recognition. We recognize license revenue addressed below in accordance with the provisions of American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*. Under SOP 97-2, as amended, we recognize revenue when all of the following conditions are met:

- persuasive evidence of an arrangement exists;
- delivery has occurred;
- the fee is fixed or determinable; and
- collection is probable.

SOP 97-2, as amended, requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of the elements. We have analyzed each element in our multiple element arrangements and determined that we have sufficient vendor-specific objective evidence (VSOE) to allocate revenues to certain OnDemand offerings, license updates and product support and professional services. Accordingly, assuming all other revenue recognition criteria are met, revenues from perpetual licenses are recognized upon delivery using the residual method in accordance with SOP 98-9. We limit our assessment of VSOE for each element to either the price charged when the same element is sold separately or the price established by management, having the relevant authority to do so, for an element not yet sold separately.

License revenues from licenses with a term of three years or more are generally recognized on delivery if the other conditions of SOP 97-2 are satisfied. We do not grant our resellers the right of return and we do not recognize revenue from resellers until an end-user has been identified and the other conditions of SOP 97-2 are satisfied. License revenues from licenses with a term of less than three years are generally recognized ratably over the term of the arrangement. License updates and product support revenue is also recognized ratably over the term of the arrangement, typically 12 months. In arrangements where term licenses are bundled with license updates and product support and such revenue is recognized ratably over the term of the arrangement, we allocate the revenue to license revenue and to license updates and product support revenue based on the VSOE of fair value for license updates and product support revenue on perpetual licenses of similar products.

Revenue related to professional services is generally recognized as the services are performed. Although we provide professional services on a time and materials basis, a portion of these services is provided on a fixed-fee basis. For services performed on a fixed fee basis, revenues are generally recognized on the proportional performance of the project, with performance measured based on hours of work performed. For contracts that involve significant customization and implementation or consulting services that are essential to the functionality of the software, the license and services revenues are recognized over the service delivery period using the percentage-of-completion method or, if we are unable to reliably estimate the costs to complete the services, we use the completed contract method of accounting in accordance with SOP 97-2 and relevant guidance of SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. A contract is considered complete when all significant costs have been incurred or the item has been accepted by the customer.

Revenue from our OnDemand offerings is recognized as a service arrangement whereby the revenue is recognized ratably over the term of the arrangement or on an as-used basis if defined in the contract. Certain of our OnDemand offerings are integrated offerings pursuant to which the customers ability to access our software is not separable from the services necessary to operate the software and customers are not allowed to take possession of our software, in which case revenue is recognized under the SEC s Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*. Our OnDemand offerings also include arrangements with customers that have separately licensed and taken possession of our software. When these OnDemand offerings are part of a multiple element arrangement involving licenses, we recognize revenue in accordance with SOP 97-2.

Table of Contents

In arrangements that include professional services and OnDemand offerings, but not a license of our software, we recognize revenue for professional services as the services are performed if these professional services qualify as a separate element of the arrangement. If the professional services do not qualify as a separate element of the arrangement, the related revenue is combined with the subscription revenue and recognized ratably over the subscription service period. Additionally, we defer the direct costs related to the professional services and recognize them ratably over the applicable service period. We categorize deferred revenue and deferred costs on our consolidated balance sheet as current if we expect to recognize such revenue or cost within the following twelve months. As of February 29, 2008, the deferred balance of the professional services revenue related to such OnDemand offerings and the related deferred costs was $736,000 and $664,000, respectively. When the revenue from professional services is recognized ratably over the subscription service period, we allocate the revenue to professional services revenue and to OnDemand revenue based on the VSOE of fair value for similar professional services that qualify as a separate element of the arrangement. Our judgment as to whether the consulting services qualify as a separate unit of accounting may materially affect the timing of our revenue recognition and our results of operations.

Allowance for doubtful accounts. Accounts receivable are recorded net of allowance for doubtful accounts and totaled $23.3 million as of February 29, 2008. The allowance for doubtful accounts, which totaled $513,000 as of February 29, 2008, is based on our assessment of the amount of probable credit losses in the existing accounts receivable. We determine the allowance based on the aging of the accounts receivable, the financial condition of our customers and their payment history, our historical write-off experience and other assumptions. Past due balances based on purchase order terms and other specific accounts as necessary are reviewed monthly. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. If there is a deterioration of a major customer s credit worthiness or actual defaults are higher than our historical experience, we may be required to increase the allowance for doubtful accounts.

Recoverability of goodwill and purchased intangible assets. We account for goodwill and other intangibles under Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*. Our goodwill balance at February 29, 2008 and May 31, 2007 was $38.3 million, including $23.5 million and $9.5 million recorded as a result of our acquisitions of Centra and THINQ, respectively. As of February 29, 2008, our purchased intangible assets balance was $13.4 million, net of accumulated amortization. The total expected future amortization related to purchased intangible assets will be approximately $947,000, for the remainder of fiscal 2008 and $3,716,000, $3,716,000, $3,268,000 and $1,759,000 in fiscal years 2009 through 2012, respectively. There is no future amortization expected after fiscal 2012 related to these purchased intangible assets.

SFAS No. 142 prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment; while the second phase, if necessary, measures the impairment. We consider Saba to be a single reporting unit. Accordingly, all of our goodwill is associated with the entire company. We perform the required impairment analysis of goodwill annually or on a more frequent basis if indicators or impairment arise or circumstances otherwise dictate. Any reduction of enterprise fair value below the recorded amount of stockholders equity could require us to write down the value of and record an expense for an impairment loss.

Restructuring costs. The total accrued restructuring balance as of February 29, 2008 was $114,000, which was comprised of facilities related charges recorded as part of the purchase accounting in the Centra acquisition. The assumptions we have made are based on the current market conditions in the various areas where we have vacant space and necessarily entail a high level of management judgment. Market conditions can fluctuate greatly due to factors such as changes in property occupancy rates and rental prices charged for comparable properties. These changes could materially affect our accrual. If, in future periods, it is determined that we have over-accrued for restructuring charges for the consolidation of facilities, the reversal of such over-accrual would have a favorable impact on our results of operations in the period this was determined and will be recorded as a credit to restructuring costs. Conversely, if it is determined that our accrual is insufficient, an additional charge would have an unfavorable impact on our results of operations in the period this was determined.

Table of Contents

Stock-based compensation. We account for share-based payments to employees, including grants of employee stock options and purchases under employee stock purchase plans in accordance with Financial Accounting Standards Board (FASB) Statement No. 123 (revised 2004) (SFAS 123R), *Share-Based Payment,* which requires that these awards (to the extent they are compensatory) be recognized in our consolidated statements of operations based on their fair values. As required by SFAS 123R, we recognize stock-based compensation expense for awards issued or assumed on or after June 1, 2006 that are expected to vest. For all awards granted or assumed beginning on or after June 1, 2006, we recognize stock-based compensation expense on a straight-line basis over the service period of the award, which is generally four years. The fair value of the unvested portion of awards granted prior to June 1, 2006 is recognized over the remaining service period using the accelerated expense attribution method, net of estimated forfeitures. SFAS 123R requires us to estimate the awards that we ultimately expect to vest and to reduce stock-based compensation expense for the effects of estimated forfeitures of awards over the expense recognition period. Although we estimate forfeitures based on historical experience, forfeitures in the future may differ. Under SFAS 123R, the forfeiture rate must be revised if actual forfeitures differ from our original estimates. Also in connection with our adoption of SFAS 123R, we elected to recognize awards granted after our adoption date under the straight-line amortization method.

We estimate the fair value of employee stock options using the Black-Scholes-Merton pricing model. The fair value of an award is affected by our stock price on the date of grant as well as other assumptions including the estimated volatility of our stock price over the term of the awards and the estimated period of time that we expect employees to hold their stock options. The risk-free interest rate assumption is based upon United States treasury interest rates appropriate for the expected life of the awards. We estimate the volatility of our common stock based upon our historical stock price volatility over the length of the expected term of the stock option. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. Our expected dividend rate is zero since we do not currently pay cash dividends on our common stock and do not anticipate doing so in the foreseeable future.

Recent Accounting Pronouncements

In June 2006, the FASB issued Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with SFAS No. 109 and prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Additionally, FIN 48 provides guidance on derecognition of tax positions, classification, interest and penalties, accounting in interim periods, disclosure and transition. We adopted FIN 48 as of June 1, 2007, and no material adjustment to retained earnings was required.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We will be required to adopt SFAS No. 157 in the first quarter of fiscal year 2009. We are currently evaluating the requirements of SFAS No. 157 and have not yet determined the impact on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 allows entities to voluntarily choose, at specified election dates, to measure certain financial assets and financial liabilities (as well as certain non-financial instruments that are similar to financial instruments) at fair value (the fair value option). The election is made on an instrument-by-instrument basis and is irrevocable. If the fair value option is elected for an instrument, SFAS No. 159 specifies that all subsequent changes in fair value for that instrument shall be reported in earnings. SFAS No. 159 is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007. We are currently evaluating the effect that SFAS No. 159 will have on our consolidated financial statements, should we decide to adopt its provisions. Should we decide to adopt SFAS No. 159, we will do so in the first quarter of fiscal year 2009.

Table of Contents

In June 2007, the FASB ratified EITF 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities*. EITF 07-3 requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and capitalized and recognized as an expense as the goods are delivered or the related services are performed. EITF 07-3 is effective, on a prospective basis, for fiscal years beginning after December 15, 2007. We will be required to adopt EITF 07-3 in the first quarter of fiscal year 2009. We are currently evaluating the requirements of EITF 07-3 and have not yet determined the impact on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised) (SFAS No. 141(R)), *Business Combinations*. SFAS No. 141(R) changes the accounting for business combinations including the measurement of acquirer shares issued in consideration for a business combination, the recognition of contingent consideration, the accounting for preacquisition gain and loss contingencies, the recognition of capitalized in-process research and development, the accounting for acquisition-related restructuring cost accruals, the treatment of acquisition related transaction costs and the recognition of changes in the acquirer s income tax valuation allowance. SFAS No. 141(R) is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. We will be required to adopt SFAS No. 141(R) in the first quarter of fiscal year 2010.

Table of Contents

RESULTS OF OPERATIONS

THREE AND NINE MONTHS ENDED FEBRUARY 29, 2008 AND 2007

Revenues

	Three months ended			
(dollars in thousands)	**February 29, 2008**	**Percent of Total Revenues**	**February 28, 2007**	**Percent of Total Revenues**
Revenues:				
License	$ 6,000	22%	$ 4,482	18%
License updates and product support	8,483	31%	8,262	33%
OnDemand	4,583	17%	4,258	17%
Professional services	8,349	30%	7,884	32%
Total revenues	$ 27,414	100%	$ 24,886	100%

	Nine months ended			
(dollars in thousands)	**February 29, 2008**	**Percent of Total Revenues**	**February 28, 2007**	**Percent of Total Revenues**
Revenues:				
License	$ 16,434	21%	$ 17,586	24%
License updates and product support	26,250	33%	22,968	31%
OnDemand	13,512	17%	11,591	15%
Professional services	23,402	29%	22,096	30%
Total revenues	$ 79,598	100%	$ 74,241	100%

Total Revenues. Total revenues increased by $2.5 million, or 10%, during the three months ended February 29, 2008 compared to the three months ended February 28, 2007. Total revenues increased by $5.4 million, or 7%, during the nine months ended February 29, 2008 compared to the nine months ended February 28, 2007. As a percentage of total revenues, revenues from customers outside the United States represented 25% and 29% for the three and nine months ended February 29, 2008 and 34% and 30% for the three and nine months ended February 28, 2007.

License Revenue. License revenue increased by $1.5 million, or 34%, during the three months ended February 29, 2008 compared to the three months ended February 28, 2007. License revenue decreased by $1.1 million, or 7%, during the nine months ended February 29, 2008 compared to the nine months ended February 28, 2007. Given the nature of license transactions, license revenues may fluctuate between quarters. During the quarter ended February 28, 2007, the timing of a few large software transactions negatively impacted our quarterly license revenue when compared to the quarter ended February 29, 2008.

License Updates and Product Support Revenue. License updates and product support revenue increased by $0.2 million or 3%, during the three months ended February 29, 2008 compared to the three months ended February 28, 2007. License updates and product support revenue increased by $3.3 million, or 14%, during the nine months ended February 29, 2008 compared to the nine months ended February 28, 2007. The increase was primarily attributable to a high rate of renewals during the prior 12 months, the addition of license update and product support revenue associated with the sale of new software licenses over the past 12 months and revenue recognized upon renewal of contracts assumed in the Centra acquisition. As a result of the Centra acquisition, license update and product support revenue during the three and nine months ended February 28, 2007 reflects a reduction in the amount of license update and product support revenue that would have been recognized by Centra as a standalone entity as required by GAAP purchase accounting. The nine month period ended February 29, 2008 includes approximately $909,000 which was recognized during the first half of fiscal 2008, related to earlier support periods that had not been renewed previously. We recognize the portion of revenue associated with the period that has lapsed upon renewal.

26

Table of Contents

OnDemand Revenue. OnDemand revenue increased by $0.3 million, or 8%, during the three months ended February 29, 2008 compared to the three months ended February 28, 2007. OnDemand revenue increased by $1.9 million, or 17%, during the nine months ended February 29, 2008 compared to the nine months ended February 28, 2007. The increase was due primarily to a high rate of renewals during the prior 12 months and revenue recognized upon renewal of contracts assumed in the Centra acquisition. As a result of the Centra acquisition, OnDemand revenue during the three and nine months ended February 28, 2007 reflects a reduction in the amount of OnDemand revenue that would have been recognized by Centra as a standalone entity as required by GAAP purchase accounting.

Professional Services Revenue. Professional services revenue increased by $0.5 million, or 6%, during the three months ended February 29, 2008 compared to the three months ended February 28, 2007. Professional services revenue increased by $1.3 million, or 6%, during the nine months ended February 29, 2008 compared to the nine months ended February 28, 2007. The increase in professional services revenue during the three and nine months ended February 29, 2008 is primarily attributable to an increase in the number of consulting projects resulting from the increase in upgrade and expansion projects from an overall increasing customer base and $0.9 million from the completion of a consulting arrangement accounted for as a completed contract under SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*.

International revenue as a percentage of total revenues and the mix of license and services revenue as a percentage of total revenues have varied significantly primarily due to variability in new license sales.

Cost of Revenues

	Three months ended			
(dollars in thousands)	**February 29, 2008**	**Percent of Total Revenues**	**February 28, 2007**	**Percent of Total Revenues**
Cost of revenues:				
Cost of license	$ 210	1%	$ 207	1%
Cost of license updates and product support	2,230	8%	2,146	8%
Cost of OnDemand	1,784	7%	1,390	6%
Cost of professional services	5,718	20%	5,415	22%
Amortization of acquired developed technology	295	1%	295	1%
Total cost of revenues	$ 10,237	37%	$ 9,453	38%

	Nine months ended			
(dollars in thousands)	**February 29, 2008**	**Percent of Total Revenues**	**February 28, 2007**	**Percent of Total Revenues**
Cost of revenues:				
Cost of license	$ 631	1%	$ 983	1%
Cost of license updates and product support	6,606	8%	6,260	8%
Cost of OnDemand	5,001	6%	3,623	5%
Cost of professional services	16,296	21%	15,462	21%
Amortization of acquired developed technology	883	1%	884	1%
Total cost of revenues	$ 29,417	37%	$ 27,212	36%

Table of Contents

The following table is a summary of gross margin:

	Three months ended	
(dollars in thousands)	**February 29, 2008**	**February 28, 2007**
Gross margin:		
License (including amortization of acquired developed technology)	$ 5,495	$ 3,980