Castle Brands Inc
Form 10-Q
February 09, 2016

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 December 31, 2015

or

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

Commission File Number 001-32849

CASTLE BRANDS INC.

(Exact name of registrant as specified in its charter)

Florida	**41-2103550**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
122 East 42nd Street, Suite 4700, New York, New York	**10168**
	(Zip Code)

(Address of principal executive offices)

Registrant’s telephone number, including area code: (646) 356-0200

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

¨ Large accelerated filer	x Accelerated filer
¨ 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

The Company had 160,034,464 shares of $.01 par value common stock outstanding at February 8, 2016.

CASTLE BRANDS INC.

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED

DECEMBER 31, 2015

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CASTLE BRANDS INC. AND SUBSIDIARIES

Consolidated Balance Sheets

	December 31, 2015 (unaudited)	March 31, 2015
ASSETS		
Current Assets		
Cash and cash equivalents	$1,896,197	$1,191,603
Accounts receivable — net of allowance for doubtful accounts of $221,687 and $154,434 at December 31 and March 31, 2015, respectively	8,797,763	10,550,990
Due from shareholders and affiliates	—	138,750
Inventories— net of allowance for obsolete and slow moving inventory of $235,545 and $266,473 at December 31 and March 31, 2015, respectively	26,979,695	21,068,241
Deferred tax asset	18,000	37,000
Prepaid expenses and other current assets	1,675,853	1,492,806
Total Current Assets	39,367,508	34,479,390
Equipment — net	782,107	665,373
Intangible assets — net of accumulated amortization of $7,207,304 and $6,713,774 at December 31 and March 31, 2015, respectively	7,213,582	7,683,227
Goodwill	496,226	496,226
Investment in non-consolidated affiliate, at equity	509,013	—
Restricted cash	331,963	329,471
Other assets	333,889	385,253
Total Assets	$49,034,288	$44,038,940
LIABILITIES AND EQUITY		
Current Liabilities		
Foreign revolving credit facility	$—	$34,141
Accounts payable	8,260,560	5,753,617
Accrued expenses	3,074,941	1,067,460
Due to shareholders and affiliates	2,082,177	1,963,883
Total Current Liabilities	13,417,678	8,819,101

Long-Term Liabilities		
Credit facility (including $298,305 of related-party participation at December 31, 2015 and none at March 31, 2015)	9,645,027	10,123,544
Bourbon term loan (including $179,063 of related-party participation at March 31, 2015)	—	744,900
Notes payable – 5% Convertible notes (including $1,100,000 of related party participation at December 31 and March 31, 2015)	1,675,000	1,675,000
Notes payable – GCP Note	219,514	211,580
Deferred tax liability	1,259,038	1,370,152
Total Liabilities	26,216,257	22,944,277
Commitments and Contingencies (Note 12)		
Equity		
Preferred stock, $.01 par value, 25,000,000 shares authorized, no shares issued and outstanding at December 31 and March 31, 2015	—	—
Common stock, $.01 par value, 300,000,000 shares authorized at December 31 and March 31, 2015, 160,034,464 and 157,187,658 shares issued and outstanding at December 31 and March 31, 2015, respectively	1,600,345	1,571,877
Additional paid-in capital	166,434,576	162,626,893
Accumulated deficit	(146,304,347)	(143,361,711)
Accumulated other comprehensive loss	(2,270,596)	(2,285,925)
Total controlling shareholders' equity	19,459,978	18,551,134
Noncontrolling interests	3,358,053	2,543,529
Total Equity	22,818,031	21,094,663
Total Liabilities and Equity	$49,034,288	$44,038,940

See accompanying notes to the unaudited consolidated financial statements.

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CASTLE BRANDS INC. AND SUBSIDIARIES

Consolidated Statements of Operations

(Unaudited)

	Three months ended December 31,		Nine months ended December 31,	
	2015	2014	2015	2014
Sales, net*	$ 17,207,372	$ 15,936,514	$ 52,256,960	$ 41,300,417
Cost of sales*	10,505,277	9,941,654	31,871,149	25,875,230
Gross profit	6,702,095	5,994,860	20,385,811	15,425,187
Selling expense	4,618,614	4,034,964	13,911,772	10,866,113
General and administrative expense	1,751,369	1,565,380	5,508,792	4,544,313
Depreciation and amortization	235,250	237,652	696,575	669,623
Income (loss) from operations	96,862	156,864	268,672	(654,862)
Other (expense) income, net	—	(208)	(221)	16,798
Foreign exchange (loss) gain	(41,634)	57,879	(131,213)	(207,579)
Interest expense, net	(271,677)	(267,459)	(786,477)	(844,316)
Income from equity investment in non-consolidated affiliate	4,500	—	9,013	—
Loss before provision for income taxes	(211,949)	(52,924)	(640,226)	(1,689,959)
Income tax expense, net	(383,962)	(258,962)	(1,487,886)	(681,886)
Net loss	(595,911)	(311,886)	(2,128,112)	(2,371,845)
Net income attributable to noncontrolling interests	(211,792)	(279,110)	(814,524)	(795,495)
Net loss attributable to common shareholders	$ (807,703)	$ (590,996)	$ (2,942,636)	$ (3,167,340)
Net loss per common share, basic and diluted, attributable to common shareholders	$ (0.01)	$ (0.00)	$ (0.02)	$ (0.02)
Weighted average shares used in computation, basic and diluted, attributable to common shareholders	160,031,891	155,838,146	159,119,831	154,989,569

* Sales, net and Cost of sales include excise taxes of $1,542,619 and $1,677,886 for the three months ended December 31, 2015 and 2014, respectively, and $5,230,618 and $4,736,838 for the nine months ended December 31, 2015 and 2014, respectively.

See accompanying notes to the unaudited consolidated financial statements.

CASTLE BRANDS INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Loss

(Unaudited)

	Three months ended December 31,		Nine months ended December 31,	
	2015	2014	2015	2014
Net loss	$ (595,911)	$ (311,886)	$ (2,128,112)	$ (2,371,845)
Other comprehensive (loss) income:				
Foreign currency translation adjustment	(58,872)	(102,589)	15,329	(311,371)
Total other comprehensive (loss) income:	(58,872)	(102,589)	15,329	(311,371)
Comprehensive loss	$ (654,783)	$ (414,475)	$ (2,112,783)	$ (2,683,216)

See accompanying notes to the unaudited consolidated financial statements.

CASTLE BRANDS INC. AND SUBSIDIARIES

Consolidated Statement of Changes in Equity

(Unaudited)

	Common Stock Shares	Amount	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Noncontrolling Interests	Total Equity
BALANCE, MARCH 31, 2015	157,187,658	$1,571,877	$162,626,893	$(143,361,711)	$(2,285,925)	$2,543,529	$21,094,663
Net loss				(2,942,636)		814,524	(2,128,112)
Foreign currency translation adjustment					15,329		15,329
Issuance of common stock, net of issuance costs of $95,344	2,119,282	21,193	3,135,452				3,156,645
Exercise of common stock options	639,289	6,393	236,701				243,094
Common stock issued under 2013 incentive compensation plan	88,235	882	119,118				120,000
Subsidiary dividend paid to non-controlling interests			(600,000)				(600,000)
Stock-based compensation			916,412				916,412
BALANCE, DECEMBER 31, 2015	160,034,464	$1,600,345	$166,434,576	$(146,304,347)	$(2,270,596)	$3,358,053	$22,818,031

See accompanying notes to the unaudited consolidated financial statements.

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CASTLE BRANDS INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(Unaudited)

	Nine months ended December 31, 2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (2,128,112)	$ (2,371,845)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	696,575	669,623
Provision for doubtful accounts	52,000	(54,333)
Amortization of deferred financing costs	138,031	114,661
Deferred income tax expense, net	(92,114)	362,216
Net income from equity investment in non-consolidated affiliate	(9,013)	—
Effect of changes in foreign currency translation	131,213	207,579
Stock-based compensation expense	1,036,412	606,817
Changes in operations, assets and liabilities:		
Accounts receivable	1,702,199	(138,383)
Due from affiliates	138,750	(23,462)
Inventory	(6,040,728)	(7,755,008)
Prepaid expenses and supplies	(183,176)	296,694
Other assets	(86,667)	(243,890)
Accounts payable and accrued expenses	4,514,429	304,061
Accrued interest	7,934	7,934
Due to related parties	118,294	420,394
Total adjustments	2,124,139	(5,225,097)
NET CASH USED IN OPERATING ACTIVITIES	(3,973)	(7,596,942)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of equipment	(299,594)	(254,296)
Acquisition of intangible assets	(23,885)	(123,245)
Investment in non-consolidated affiliate, at equity	(500,000)	—
Change in restricted cash	(208)	(812)
NET CASH USED IN INVESTING ACTIVITIES	(823,687)	(378,353)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net (payments on) proceeds from credit facility	(478,517)	7,503,066
Payments on Bourbon term loan	(744,900)	(875,550)
Payments on Junior loan	—	(1,250,000)
Net (payments on) proceeds from foreign revolving credit facility	(34,757)	(19,329)

Proceeds from issuance of common stock	3,251,989	1,916,399
Payments for costs of stock issuance	(95,344)	(158,189)
Subsidiary dividend paid to non-controlling interests	(600,000)	—
Proceeds from exercise of common stock warrants	—	598,715
Proceeds from exercise of common stock options	243,094	215,694
NET CASH PROVIDED BY FINANCING ACTIVITIES	1,541,565	7,930,806
EFFECTS OF FOREIGN CURRENCY TRANSLATION	(9,311)	(9,781)
NET INCREASE IN CASH AND CASH EQUIVALENTS	704,594	(54,270)
CASH AND CASH EQUIVALENTS — BEGINNING	1,191,603	908,501
CASH AND CASH EQUIVALENTS — ENDING	$ 1,896,197	$ 854,231
SUPPLEMENTAL DISCLOSURES:		
Schedule of non-cash investing and financing activities:		
Surrender of common stock in connection with exercise of common stock warrant	$ —	$ 31,250
Conversion of 5% convertible note to common stock	$ —	$ 451,417
Interest paid	$ 652,262	$ 707,148
Income taxes paid	$ 1,079,387	$ 176,523

See accompanying notes to the unaudited consolidated financial statements.

CASTLE BRANDS INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements

NOTE 1 — ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying unaudited consolidated financial statements do not include all of the information and footnote disclosures normally included in financial statements prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC") and U.S. generally accepted accounting principles ("GAAP") and, in the opinion of management, contain all adjustments (which consist of only normal recurring adjustments) necessary for a fair presentation of such financial information. Results of operations for interim periods are not necessarily indicative of those to be achieved for full fiscal years. The consolidated balance sheet as of March 31, 2015 is derived from the March 31, 2015 audited financial statements. These unaudited consolidated financial statements should be read in conjunction with Castle Brands Inc.'s (the "Company") audited consolidated financial statements for the fiscal year ended March 31, 2015 included in the Company's annual report on Form 10-K for the year ended March 31, 2015, as amended ("2015 Form 10-K"). Please refer to the notes to the audited consolidated financial statements included in the 2015 Form 10-K for additional disclosures and a description of accounting policies.

A. Basis of presentation — The consolidated financial statements include the accounts of the Company, its wholly-owned domestic subsidiaries, Castle Brands (USA) Corp. ("CB-USA") and McLain & Kyne, Ltd. ("McLain & Kyne"), the Company's wholly-owned foreign subsidiaries, Castle Brands Spirits Group Limited ("CB-IRL") and Castle Brands Spirits Marketing and Sales Company Limited, and the Company's 60% ownership interest in Gosling-Castle Partners Inc. ("GCP"), with adjustments for income or loss allocated based upon percentage of ownership. The accounts of the subsidiaries have been included as of the date of acquisition. All significant intercompany transactions and balances have been eliminated.

B. Organization and operations — The Company is principally engaged in the importation, marketing and sale of premium and super premium rums, whiskey, liqueurs, vodka, tequila and related non-alcoholic beverage products in the United States, Canada, Europe and Asia.

C. Equity investments — Equity investments are carried at original cost adjusted for the Company's proportionate share of the investees' income, losses and distributions. The Company assesses the carrying value of its equity investments when an indicator of a loss in value is present and records a loss in value of the investment when the assessment indicates that an other-than-temporary decline in the investment exists. The Company classifies its equity earnings of equity investments as a component of net income or loss.

D. Goodwill and other intangible assets — Goodwill represents the excess of purchase price including related costs over the value assigned to the net tangible and identifiable intangible assets of businesses acquired. Goodwill and other

identifiable intangible assets with indefinite lives are not amortized, but instead are tested for impairment annually, or more frequently if circumstances indicate a possible impairment may exist. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives, generally on a straight-line basis, and are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

E. Impairment of long-lived assets — Under Accounting Standards Codification (“ASC”) 310, “Accounting for the Impairment or Disposal of Long-lived Assets”, the Company periodically reviews whether changes have occurred that would require revisions to the carrying amounts of its definite lived, long-lived assets. When the sum of the expected future cash flows is less than the carrying amount of the asset, an impairment loss is recognized based on the fair value of the asset. There have been no impairments recorded during the nine-month periods ended December 31, 2015 and 2014.

F. Excise taxes and duty — Excise taxes and duty are computed at standard rates based on alcohol proof per gallon/liter and are paid after finished goods are imported into the United States or other relevant jurisdiction and then transferred out of “bond.” Excise taxes and duty are recorded to inventory as a component of the cost of the underlying finished goods. When the underlying products are sold “ex warehouse”, the sales price reflects the taxes paid and the inventoried excise taxes and duties are charged to cost of sales.

G. Foreign currency — The functional currency for the Company’s foreign operations is the Euro in Ireland and the British Pound in the United Kingdom. Under ASC 830, “Foreign Currency Matters”, the translation from the applicable foreign currencies to U.S. Dollars is performed for balance sheet accounts using exchange rates in effect at the balance sheet date and for revenue and expense accounts using a weighted average exchange rate during the period. The resulting translation adjustments are recorded as a component of other comprehensive income. Gains or losses resulting from foreign currency transactions are shown as a separate line item in the consolidated statements of operations.

CASTLE BRANDS INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements - Continued

H. Income taxes — Under ASC 740, “Income Taxes”, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. A valuation allowance is provided to the extent a deferred tax asset is not considered recoverable.

The Company has not recognized any adjustments for uncertain tax positions. The Company recognizes interest and penalties related to uncertain tax positions in general and administrative expense; however, no such provisions for accrued interest and penalties related to uncertain tax positions have been recorded by the Company.

The Company’s income tax expense for the three-month and nine-month periods ended December 31, 2015 and 2014 principally consists of federal, state and local taxes attributable to GCP, which does not file a consolidated income tax return with the Company. In connection with the investment in GCP, the Company recorded a deferred tax liability on the ascribed value of the acquired intangible assets of $2,222,222, increasing the value of the assets. The difference between the book basis and tax basis created a deferred tax liability that is being amortized over a period of 15 years (the life of the licensing agreement) on a straight-line basis. For the three months ended December 31, 2015 the Company recognized ($383,962) of income tax expense, net, of which ($386,000) was current period expense and $2,038 was deferred tax benefit. For the three months ended December 31, 2014, the Company recognized ($258,962) of income tax expense, net, of which ($30,000) was current period expense and ($228,962) was deferred tax expense, net. For the nine months ended December 31, 2015 the Company recognized ($1,487,886) of income tax expense, net, of which ($1,580,000) was current period expense and $92,114 was deferred tax benefit. For the nine months ended December 31, 2014, the Company recognized ($681,886) of income tax expense, net, of which ($80,000) was current period expense and ($601,886) was deferred tax expense, net. The Company allocated 40% of the net expense, or ($153,583) and ($103,585), to non-controlling interest for the three months ended December 31, 2015 and 2014, respectively, and ($595,154) and ($272,754), to non-controlling interest for the nine months ended December 31, 2015 and 2014, respectively.

I. Recent accounting pronouncements — In November 2015, the Financial Accounting Standards Board (“FASB”) issued Accounting Standard Update (“ASU”) 2015-17—Balance Sheet Classification of Deferred Taxes. As part of the FASB's accounting simplification initiative, ASU 2015-17 removes the requirement to separate deferred income tax liabilities and assets into current and noncurrent amounts in a classified statement of financial position. Instead, the update requires that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. ASU 2015-17 is effective for entities for fiscal years beginning after December 15, 2016, with retrospective application to all periods presented. Early adoption is permitted, and the Company plans to adopt this guidance beginning with its upcoming Annual Report on Form 10-K for the fiscal year ending March 31, 2016. The Company does not expect this new accounting guidance will have a significant impact on its consolidated financial statements.

In September 2015, the FASB issued ASU 2015-16, Business Combination (Topic 805): Simplifying the Accounting for Measurement Period Adjustments, which requires adjustments to provisional amounts initially recorded in a business combination that are identified during the measurement period to be recognized in the reporting period in which the adjustment amounts are determined. This includes any effect on earnings of changes in depreciation, amortization, or other income effects as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. ASU 2015-16 also requires the disclosure of the nature and amount of measurement-period adjustments recognized in the current period, including separately the amounts in current-period income statement line items that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. The guidance is effective for the Company beginning April 1, 2016. The Company will apply the guidance prospectively for all business combinations that occur subsequent to the adoption date.

In July 2015, the FASB issued ASU 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory, which changes the measurement principle for inventory from the lower of cost or market to the lower of cost and net realizable value. Net realizable value is defined as estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The new guidance must be applied on a prospective basis and is effective for periods beginning after April 1, 2017, with early adoption permitted. The Company is currently evaluating the new guidance to determine the impact the adoption of this guidance will have on the Company’s results of operations, cash flows and financial condition.

CASTLE BRANDS INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements - Continued

In April 2015, the FASB issued ASU 2015-03, Simplifying the Presentation of Debt Issuance Costs, which requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected. Upon adoption, the Company will apply the new guidance on a retrospective basis and adjust the balance sheet of each individual period presented to reflect the period-specific effects of applying the new guidance. This guidance is effective for the Company beginning April 1, 2016. In June, 2015, the FASB issued ASU No. 2015-15, Interest - Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements - Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting. This update addresses presentation and subsequent measurement of debt issuance costs related to line-of credit arrangements. Commitment fees paid to the lender represent the benefit of being able to access capital over the contractual term, and therefore, are not in the scope of the new guidance and is appropriate to present such fees as an asset on the balance sheet, regardless of whether or not there are outstanding borrowings under the revolver. The Company is currently evaluating the new guidance to determine the impact the adoption of this guidance will have on the Company’s results of operations, cash flows and financial condition.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, to clarify the principles for recognizing revenue. This guidance includes the required steps to achieve the core principle that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This guidance is effective for fiscal years and interim periods beginning after December 15, 2016. Early adoption is not permitted. On July 9, 2015, the FASB agreed to delay the effective date by one year. In accordance with the delay, the new standard is effective for fiscal years and interim periods beginning after December 15, 2017. Early adoption is permitted, but not before the original effective date of the standard. The Company is currently evaluating the new guidance to determine the impact the adoption of this guidance will have on the Company’s results of operations, cash flows and financial condition but does not expect this new accounting guidance will have a significant impact on its consolidated financial statements.

The Company does not believe that any other recently issued, but not yet effective, accounting standards, if currently adopted, would have a material effect on the accompanying financial statements.

NOTE 2 — BASIC AND DILUTED NET LOSS PER COMMON SHARE

Basic net loss per common share is computed by dividing net loss by the weighted average number of common shares outstanding during the period. Diluted net loss per common share is computed giving effect to all potentially dilutive

common shares that were outstanding during the period that are not anti-dilutive. Potentially dilutive common shares consist of incremental shares issuable upon exercise of stock options and warrants or conversion of convertible notes outstanding. In computing diluted net loss per share for the three and nine months ended December 31, 2015 and 2014, no adjustment has been made to the weighted average outstanding common shares as the assumed exercise of outstanding options and warrants and the assumed conversion of convertible notes is anti-dilutive.

Potential common shares not included in calculating diluted net loss per common share are as follows:

	Nine months ended December 31,	
	2015	2014
Stock options	13,831,399	12,750,713
Warrants to purchase common stock	—	120,000
5% Convertible notes	1,861,111	1,861,111
Total	15,692,510	14,731,824

NOTE 3 — INVENTORIES

	December 31, 2015	March 31, 2015
Raw materials	$ 13,435,511	$ 9,250,893
Finished goods – net	13,544,184	11,817,348
Total	$ 26,979,695	$ 21,068,241

As of December 31 and March 31, 2015, 8% and 10% of raw materials, respectively, and 7% and 4% of finished goods, respectively, were located outside of the United States.

CASTLE BRANDS INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements - Continued

The Company estimates the allowance for obsolete and slow moving inventory based on analyses and assumptions including, but not limited to, historical usage, expected future demand and market requirements.

Inventories are stated at the lower of weighted average cost or market.

NOTE 4 — INVESTMENTS

Investment in Gosling-Castle Partners Inc., consolidated

For the three months ended December 31, 2015 and 2014, GCP had pretax net income on a stand-alone basis of $950,481 and $963,774, respectively. For the nine months ended December 31, 2015 and 2014, GCP had pretax net income on a stand-alone basis of $3,635,312 and $2,701,738, respectively. The Company allocated 40% of this net income, or $380,193 and $385,510, to non-controlling interest for the three months ended December 31, 2015 and 2014, respectively, and $1,454,125 and $1,080,695, to non-controlling interest for the nine months ended December 31, 2015 and 2014, respectively. Combined with the effects of income tax expense, net, allocated to noncontrolling interests as described in Note 1.H Income Taxes, the cumulative balance allocated to noncontrolling interests in GCP was $3,358,053 and $2,543,529 at December 31 and March 31, 2015, respectively, as shown on the accompanying consolidated balance sheets.

In September 2015, GCP declared and paid a $1,500,000 cash dividend to its shareholders. The Company recorded 60% of this dividend, or $900,000, as a return of capital and a reduction of its investment in GCP, and allocated 40% of this dividend, or $600,000, to noncontrolling interests and a reduction in the additional paid-in capital of GCP.

Investment in Copperhead Distillery Company, equity method

In June 2015, CB-USA purchased 20% of Copperhead Distillery Company ("Copperhead") for $500,000. Copperhead owns and operates the Kentucky Artisan Distillery. The investment is part of an agreement to build a new warehouse to store Jefferson's bourbons, provide distilling capabilities using special mash-bills made from locally grown grains and create a visitor center and store to enhance the consumer experience for the Jefferson's brand. The investment has been used for the construction of a new warehouse in Crestwood, Kentucky dedicated exclusively to the storage of Jefferson's whiskies. The Company has accounted for this investment under the equity method of accounting. For the three and nine-month periods ended December 31, 2015, the Company recognized $4,500 and $9,013, respectively, of income from this investment. The investment balance was $509,013 at December 31, 2015.

NOTE 5 — GOODWILL AND INTANGIBLE ASSETS

The carrying amount of goodwill was $496,226 at each of December 31 and March 31, 2015.

Intangible assets consist of the following:

	December 31, 2015	March 31, 2015
Definite life brands	$ 170,000	$ 170,000
Trademarks	631,693	631,693
Rights	8,271,555	8,271,555
Product development	185,206	161,321
Patents	994,000	994,000
Other	55,460	55,460
	10,307,914	10,284,029
Less: accumulated amortization	7,207,304	6,713,774
Net	3,100,610	3,570,255
Other identifiable intangible assets — indefinite lived*	4,112,972	4,112,972
	$ 7,213,582	$ 7,683,227

* Other identifiable intangible assets — indefinite lived consists of product formulations and the Company's relationships with its distillers.

CASTLE BRANDS INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements - Continued

Accumulated amortization consists of the following:

	December 31, 2015	March 31, 2015
Definite life brands	$ 170,000	$ 170,000
Trademarks	322,537	295,956
Rights	5,927,124	5,513,162
Product development	27,289	24,002
Patents	760,354	710,654
Other	-	-
Accumulated amortization	$ 7,207,304	$ 6,713,774

NOTE 6 — RESTRICTED CASH

At December 31 and March 31, 2015, the Company had €304,358 or $331,963 (translated at the December 31, 2015 exchange rate) and €303,657 or $329,471 (translated at the March 31, 2015 exchange rate), respectively, of cash restricted from withdrawal and held by a bank in Ireland as collateral for overdraft coverage, creditors' insurance, customs and excise guaranty and a revolving credit facility as described in Note 7A below.

NOTE 7 — NOTES PAYABLE

	December 31, 2015	March 31, 2015
Notes payable consist of the following:		
Foreign revolving credit facilities (A)	$ —	$ 34,141
Note payable – GCP note (B)	219,514	211,580
Credit facility (C)	9,645,027	10,123,544
Bourbon term loan (D)	—	744,900
5% Convertible notes (E)	1,675,000	1,675,000
Total	$ 11,539,541	$ 12,789,165

A. The Company has arranged various facilities aggregating €304,358 or $331,963 (translated at the December 31, 2015 exchange rate) with an Irish bank, including overdraft coverage, creditors' insurance, customs and excise guaranty, and a revolving credit facility. These facilities are payable on demand, continue until terminated by either party, are subject to annual review, and call for interest at the lender's AA1 Rate minus 1.70%. The balance on the credit facilities included in notes payable totaled €0 and €31,466 or $34,141 (translated at the March 31, 2015 exchange rate), at December 31 and March 31, 2015, respectively.

B. In December 2009, GCP issued a promissory note (the "GCP Note") in the aggregate principal amount of $211,580 to Gosling's Export (Bermuda) Limited in exchange for credits issued on certain inventory purchases. The GCP Note matures on April 1, 2020, is payable at maturity, subject to certain acceleration events, and calls for annual interest of 5%, to be accrued and paid at maturity. At March 31, 2015, $10,579 of accrued interest was converted to amounts due to affiliates. At December 31, 2015, $219,514, consisting of $211,580 of principal and $7,934 of accrued interest, due on the GCP Note is included in long-term liabilities. At March 31, 2015, $211,580 of principal due on the GCP Note is included in long-term liabilities.

CASTLE BRANDS INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements - Continued

In August 2011, the Company and CB-USA entered into a loan agreement with Keltic Financial Partners II, LP (“Keltic”), which, as amended, provides for availability (subject to certain terms and conditions) of a facility of up to $19.0 million (the “Credit Facility”) for the purpose of providing the Company with working capital.

C. In September 2014, the Company and CB-USA entered into an Amended and Restated Loan and Security Agreement (as amended, the “Amended Agreement”) with ACF FinCo I LP (“ACF”), as successor in interest to Keltic, in order to amend certain terms of the Credit Facility and the Bourbon Term Loan (defined below). Among other changes, the Amended Agreement modified certain aspects of the existing Credit Facility, including increasing the maximum amount of the Credit Facility from $8,000,000 to $12,000,000 and increasing the inventory sub-limit from $4,000,000 to $6,000,000. In addition, the term of the Credit Facility was extended from December 31, 2016 to July 31, 2019. The Credit Facility interest rate is the rate that, when annualized, is the greatest of (a) the Prime Rate plus 3.00%, (b) the LIBOR Rate plus 5.50% and (c) 6.00%. As of December 31, 2015, the Credit Facility interest rate was 6.00%. The monthly facility fee is 0.75% per annum of the maximum Credit Facility. The Amended Agreement contains EBITDA targets allowing for further interest rate reductions in the future. The Company paid ACF an aggregate $120,000 amendment fee in connection with the execution of the Amended Agreement.

In connection with the amendment, the Company and CB-USA entered into the following ancillary agreements: (i) a Reaffirmation Agreement with (a) certain officers of the Company and CB-USA, including John Glover, the Company’s Chief Operating Officer, T. Kelley Spillane, the Company’s Senior Vice President - Global Sales, and Alfred Small, the Company’s Senior Vice President, Chief Financial Officer, Treasurer and Secretary, (b) certain participants in the Bourbon Term Loan and (c) certain junior lenders to the Company, including Frost Gamma Investments Trust, an entity affiliated with Phillip Frost, M.D., a director and principal shareholder of the Company, Mark E. Andrews, III, a director of the Company and the Company’s Chairman, an affiliate of Richard J. Lampen, a director of the Company and the Company’s President and Chief Executive Officer, an affiliate of Glenn Halpryn, a director of the Company, Dennis Scholl, a former director of the Company, and Vector Group Ltd., a more than 5% shareholder of the Company, of which Richard Lampen is an executive officer, Henry Beinstein, a director of the Company, is a director and Phillip Frost M.D. is a principal shareholder, which, among other things, reaffirms the existing Validity and Support Agreements by and among each officer, the Company, CB-USA and ACF, as successor-in-interest to Keltic; (ii) an Amended and Restated Term Note; and (iii) an Amended and Restated Revolving Credit Note.

In connection with the Amended Agreement, on September 22, 2014, ACF entered into an amendment to that certain Subordination Agreement, dated as of August 7, 2013 (as amended, the “Subordination Agreement”), by and among ACF, as successor-in-interest to Keltic, and certain junior lenders to the Company; neither the Company nor CB-USA is a party to the Subordination Agreement.

In August 2015, the Company and CB-USA entered into a First Amendment (the “Loan Agreement Amendment”) to the Amended Agreement. Among other changes, the Loan Agreement Amendment increased the amount of the Credit Facility from $12,000,000 to $19,000,000, including a sublimit in the maximum principal amount of $7,000,000 to permit the Company to acquire aged whiskey inventory (the “Purchased Inventory Sublimit”) subject to certain conditions set forth in the Amended Agreement. The maturity date remained unchanged at July 31, 2019. The Company and CB-USA are permitted to prepay the Credit Facility in whole or the Purchased Inventory Sublimit, in whole or in part, subject to certain prepayment penalties as set forth in the Loan Agreement Amendment. The Purchased Inventory Sublimit replaces the Bourbon Term Loan, which was paid in full in the normal course of business. The Purchased Inventory Sublimit interest rate is the rate that, when annualized, is the greatest of (a) the Prime Rate plus 4.25%, (b) the LIBOR Rate plus 6.75% and (c) 7.50%. As of December 31, 2015, the interest rate applicable to the Purchased Inventory Sublimit was 7.50%. The monthly facility fee remains 0.75% per annum of the maximum principal amount of the Credit Facility (excluding the Purchased Inventory Sublimit). Also, the Company must pay a monthly facility fee of $2,000 with respect to the Purchased Inventory Sublimit until all obligations with respect thereof are fully paid and performed. The Company paid ACF an aggregate $45,000 commitment fee in connection with the Loan Agreement Amendment.

In connection with the Loan Agreement Amendment, the Company and CB-USA entered into the following ancillary agreements: (i) a Reaffirmation Agreement with (a) certain officers of the Company and CB-USA, including John Glover, T. Kelley Spillane and Alfred J. Small and (b) certain junior lenders to the Company, including Frost Gamma Investments Trust, Mark E. Andrews, III, an affiliate of Richard J. Lampen, an affiliate of Glenn Halpryn, Dennis Scholl and Vector Group Ltd., which, among other things, reaffirms the existing Validity and Support Agreements by and among each officer, the Company, CB-USA and ACF and (ii) an Amended and Restated Revolving Credit Note.

CASTLE BRANDS INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements - Continued

ACF also required as a condition to entering into the Loan Agreement Amendment that ACF enter into a participation agreement with certain related parties of the Company, including Frost Gamma Investments Trust, Mark E. Andrews, III, Richard J. Lampen and Alfred J. Small, to allow for the sale of participation interests in the Purchased Inventory Sublimit and the inventory purchased with the proceeds thereof. The participation agreement provides that ACF's commitment to fund each advance of the Purchased Inventory Sublimit shall be limited to seventy percent (70%), up to an aggregate maximum principal amount for all advances equal to $4,900,000. Neither the Company nor CB-USA is a party to the participation agreement. However, the Company and CB-USA are party to a fee letter with the junior participants (including the related party junior participants) pursuant to which the Company and CB-USA were obligated to pay the junior participants a closing fee of $18,000 on the effective date of the Loan Agreement Amendment and are obligated to pay a commitment fee of $18,000 on each anniversary of the effective date until the junior participants' obligations are terminated pursuant to the participation agreement.

The Company and CB-USA are referred to individually and collectively as the Borrower. Pursuant to the Loan Agreement Amendment, the Company and CB-USA may borrow up to the lesser of (x) $19,000,000 and (y) the sum of the borrowing base calculated in accordance with the Amended Agreement and the Purchased Inventory Sublimit. For the nine months ended December 31, 2015 and 2014, the Company paid interest at 6.0% and 6.5%, respectively and paid interest at 7.5% on the Purchased Inventory Sublimit for the nine months ended December 31, 2015. Interest is payable monthly in arrears, on the first day of every month on the average daily unpaid principal amount of the Credit Facility. After the occurrence and during the continuance of any "Default" or "Event of Default" (as defined under the Amended Agreement), the Borrower is required to pay interest at a rate that is 3.25% per annum above the then applicable Credit Facility interest rate. There have been no Events of Default under the Credit Facility. ACF also receives a collateral management fee of $1,000 per month (increased to $2,000 after the occurrence of and during the continuance of an Event of Default) in addition to the facility fee with respect to the Purchased Inventory Sublimit. The Amended Agreement contains standard borrower representations and warranties for asset-based borrowing and a number of reporting obligations and affirmative and negative covenants. The Amended Agreement includes negative covenants that, among other things, restrict the Borrower's ability to create additional indebtedness, dispose of properties, incur liens and make distributions or cash dividends. The obligations of the Borrower under the Loan Agreement Amendment are secured by the grant of a pledge and security interest in all of the assets of the Borrower. At December 31, 2015, the Company was in compliance, in all respects, with the covenants under the Amended Agreement.

In August 2015, the Company used $3,000,000 of the Purchased Inventory Sublimit to acquire aged bourbon inventory. Frost Gamma Investments Trust ($150,000), Mark E. Andrews, III ($50,000), Richard J. Lampen ($100,000) and Alfred J. Small ($15,000) each acquired participation interests in the Purchased Inventory Sublimit and the inventory purchased with the proceeds thereof. Under the terms of the participation agreement, the participants receive interest at the rate of 11% per annum. At December 31 and March 31, 2015, $9,645,027 and $10,123,544, respectively, due on the Credit Facility was included in long-term liabilities.

D.

In March 2013, the Company and CB-USA entered into an inventory term loan of $2,496,000 (the “Bourbon Term Loan”) that was used to purchase bourbon inventory on March 11, 2013. In August 2013, the Bourbon Term Loan was amended to provide the Company with the ability to increase the maximum aggregate principal amount of the Bourbon Term Loan from $2,500,000 to up to $4,000,000 to finance the purchase of aged whiskies following the identification of junior participants to purchase a portion of the increased Bourbon Term Loan amount. The Bourbon Term Loan interest rate was the rate that, when annualized, was the greatest of (a) the Prime Rate plus 4.25%, (b) the LIBOR Rate plus 6.75% and (c) 7.50%. As of March 31, 2015, the Company paid interest of 7.5%.

Keltic required as a condition to funding the Bourbon Term Loan that Keltic had entered into a participation agreement (the “Participation Agreement”) providing for an initial aggregate amount of $750,000 of the Bourbon Term Loan to be purchased by junior participants. Certain related parties of the Company purchased a portion of these junior participations in the Bourbon Term Loan, including Frost Gamma Investments Trust ($500,000), Mark E. Andrews, III ($50,000) and an affiliate of Richard J. Lampen ($50,000) (amounts shown are initial purchase amounts). Under the terms of the Participation Agreement, the junior participants received interest at the rate of 11% per annum. Neither the Company nor CB-USA was a party to the Participation Agreement. However, the Borrower was party to a fee letter with the junior participants (including the related party junior participants) pursuant to which the Borrower was obligated to pay the junior participants an aggregate commitment fee of $45,000 in three equal annual installments of $15,000.

The balance on the Bourbon Term Loan included in notes payable totaled $744,900 at March 31, 2015. In May 2015, the Bourbon Term Loan was paid in full in accordance with its terms.

CASTLE BRANDS INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements - Continued

In October 2013, the Company entered into a 5% Convertible Subordinated Note Purchase Agreement (the “Note Purchase Agreement”) with the purchasers party thereto, under which the Company issued an aggregate initial principal amount of $2,125,000 of unsecured subordinated notes (the “Convertible Notes”). The Convertible Notes bear interest at a rate of 5% per annum, payable quarterly, until their maturity date of December 15, 2018. The Convertible Notes, and accrued but unpaid interest thereon, are convertible in whole or in part from time to time at the option of the holders thereof into shares of the Company’s common stock at a conversion price of $0.90 per share (the “Conversion Price”). The Convertible Notes may be prepaid in whole or in part at any time without penalty or premium, but with payment of accrued interest to the date of prepayment. The Convertible Notes contain customary events of default, which, if uncured, entitle each note holder to accelerate the due date of the unpaid principal amount of, and all accrued and unpaid interest on, the Convertible Notes.

The purchasers of the Convertible Notes included related parties of the Company, including an affiliate of Dr. Phillip Frost ($500,000), Mark E. Andrews, III ($50,000), an affiliate of Richard J. Lampen ($50,000), an affiliate of Glenn Halpryn ($200,000), Dennis Scholl ($100,000), and Vector Group Ltd. ($200,000).

E.

The Company may forcibly convert all or any part of the Convertible Notes and all accrued but unpaid interest thereon if (i) the average daily volume of the Company’s common stock (as reported on the principal market or exchange on which the common stock is listed or quoted for trading) exceeds $50,000 per trading day and (ii) the volume weighted average price of the common stock for at least twenty (20) trading days during any thirty (30) consecutive trading day period exceeds 250% of the then-current Conversion Price. Any forced conversion will be applied ratably to the holders of all Convertible Notes issued pursuant to the Note Purchase Agreement based on each holder’s then-current note holdings.

In connection with the Note Purchase Agreement, each purchaser of the Convertible Notes was required to execute a joinder to the subordination agreement, by and among Keltic and certain other junior lenders to the Company; the Company is not a party to the Subordination Agreement.

At each of December 31 and March 31, 2015, $1,675,000 of principal due on the Convertible Notes was included in long-term liabilities.

NOTE 8 — EQUITY

Equity distribution agreement - In November 2014, the Company entered into an Equity Distribution Agreement (the "2014 Distribution Agreement") with Barrington Research Associates, Inc. ("Barrington"), as sales agent, under which the Company may issue and sell over time and from time to time, to or through Barrington, shares (the "Shares") of its common stock having a gross sales price of up to $10,000,000.

Sales of the Shares pursuant to the 2014 Distribution Agreement, if any, may be effected by any method permitted by law deemed to be an "at-the-market" offering as defined in Rule 415 of the Securities Act of 1933, as amended, including without limitation directly on the NYSE MKT LLC or any other existing trading market for the common stock or through a market maker, up to the amount specified, and otherwise to or through Barrington in accordance with the placement notices delivered by the Company to Barrington. Also, with the prior consent of the Company, some of the Shares may be sold in privately negotiated transactions. Under the 2014 Distribution Agreement, Barrington is entitled to compensation of 2.0% of the gross proceeds from the sale of Shares sold through Barrington, as sales agent. Also, the Company reimburses Barrington for certain expenses incurred in connection with the matters contemplated by the 2014 Distribution Agreement, up to an aggregate of $50,000, plus up to an additional $7,500 per calendar quarter related to ongoing maintenance; provided, however, that such reimbursement amount shall not exceed 8% of the aggregate gross proceeds received by the Company under the 2014 Distribution Agreement.

In the nine months ended December 31, 2015, the Company sold 2,119,282 Shares pursuant to the 2014 Distribution Agreement, with total gross proceeds of $3,251,989, before deducting sales agent and issuance costs of $95,344. No Shares were sold in the three months ended December 31, 2015.

From November 2014 through December 31, 2014, the Company sold 419,616 Shares pursuant to the 2014 Distribution Agreement, with total gross proceeds of $685,158, before deducting sales agent and offering expenses of $93,990.

In November 2013, the Company entered into an Equity Distribution Agreement (the "2013 Distribution Agreement") with Barrington, as sales agent, under which the Company could issue and sell over time and from time to time, to or through Barrington, Shares of its common stock having a gross sales price of up to $6,000,000.

In the three months ended June 30, 2014, the Company sold 1,247,343 Shares pursuant to the 2013 Distribution Agreement, with total gross proceeds of $1,231,241, before deducting sales agent and offering expenses of $64,198. No Shares were sold in the six-month period from July 1, 2014 through December 31, 2014 under the 2013 Distribution Agreement.

CASTLE BRANDS INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements - Continued

The 2013 Distribution Agreement expired in August 2014 upon the expiration of the primary portion of the Company's Registration Statement on Form S-3 under which the Shares were sold.

Subsidiary dividend - In September 2015, GCP declared and paid a $1,500,000 cash dividend to its shareholders. The Company allocated 40% of this dividend, or $600,000, to non-controlling interests.

NOTE 9 — WARRANTS

2011 Warrants exercised – On April 2, 2014, the Company called for cancellation all 1,657,802 unexercised warrants issued in connection with the Company's 2011 private placement (the "2011 Warrants") pursuant to the terms of such 2011 Warrants after satisfying applicable conditions. Holders of the 2011 Warrants had until 6:30 p.m. New York City time on April 21, 2014 to exercise such 2011 Warrants at $0.38 per share in cash. Pursuant to the call for cancellation, holders of all 1,657,802 unexercised 2011 Warrants exercised and received 1,657,802 shares of common stock. The Company received $629,965 in cash upon the exercise of these warrants.

NOTE 10 — FOREIGN CURRENCY FORWARD CONTRACTS

The Company enters into forward contracts from time to time to reduce its exposure to foreign currency fluctuations. The Company recognizes in the balance sheet derivative contracts at fair value, and reflects any net gains and losses currently in earnings. At December 31 and March 31, 2015, the Company had no forward contracts outstanding. Gain or loss on foreign currency forward contracts, which was de minimis during the periods presented, is included in other income and expense.

NOTE 11 — STOCK-BASED COMPENSATION

In June 2015, the Company granted to employees, directors and certain consultants options to purchase an aggregate of 2,502,500 shares of the Company's common stock at an exercise price of $1.67 per share under the Company's 2013

Incentive Compensation Plan (the "Plan"). The options, which expire in June 2025, vest 25% on each of the first four anniversaries of the grant date. The Company has valued the options at $2,752,750 using the Black-Scholes option pricing model.

In September 2015, the Company issued 88,235 shares of fully vested common stock, or $120,000 at the then closing price on the grant date, as additional compensation to E. Malcolm Gosling, President and CEO of GCP.

Stock-based compensation expense for the three months ended December 31, 2015 and 2014 and for the nine months ended December 31, 2015 and 2014 amounted to $338,023 and $206,553, respectively, and $1,036,412 and $606,817, respectively. At December 31, 2015, total unrecognized compensation cost amounted to $3,435,753, representing 5,629,467 unvested options. This cost is expected to be recognized over a weighted-average vesting period of 2.78 years. There were 639,289 options exercised during the nine months ended December 31, 2015 and 652,294 options exercised during the nine months ended December 31, 2014. The Company did not recognize any related tax benefit for the three months ended December 31, 2015 and 2014 from option exercises, as the effects were de minimis.

NOTE 12 — COMMITMENTS AND CONTINGENCIES

A. The Company has entered into a supply agreement with Irish Distillers Limited ("IDL"), which provides for the production of blended Irish whiskeys for the Company until the contract is terminated by either party in accordance with the terms of the agreement. IDL may terminate the contract if it provides at least six years prior notice to the Company, except for breach. Under this agreement, the Company provides IDL with a forecast of the estimated amount of liters of pure alcohol it requires for the next four fiscal contract years and agrees to purchase 90% of that amount, subject to certain annual adjustments. For the contract year ending June 30, 2016, the Company has contracted to purchase approximately €833,673 or $909,287 (translated at the December 31, 2015 exchange rate) in bulk Irish whiskey, of which €554,715 or $605,028 (translated at the December 31, 2015 exchange rate), has been purchased as of December 31, 2015. The Company is not obligated to pay IDL for any product not yet received. During the term of this supply agreement, IDL has the right to limit additional purchases above the commitment amount.

CASTLE BRANDS INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements - Continued

B. The Company has also entered into a supply agreement with IDL, which provides for the production of single malt Irish whiskeys for the Company until the contract is terminated by either party in accordance with the terms of the agreement. IDL may terminate the contract if it provides at least thirteen years prior notice to the Company, except for breach. Under this agreement, the Company provides IDL with a forecast of the estimated amount of liters of pure alcohol it requires for the next twelve fiscal contract years and agrees to purchase 80% of that amount, subject to certain annual adjustments. For the contract year ending June 30, 2016, the Company has contracted to purchase approximately €343,787 or $374,868 (translated at the December 31, 2015 exchange rate) in bulk Irish whiskey of which €288,781 or $314,973 (translated at the December 31, 2015 exchange rate), has been purchased as of December 31, 2015. The Company is not obligated to pay IDL for any product not yet received. During the term of this supply agreement, IDL has the right to limit additional purchases above the commitment amount.

C. The Company has entered into a supply agreement with a bourbon distiller, which provides for the production of newly distilled bourbon whiskey through December 31, 2019. Under this agreement, the distiller provides the Company with an agreed upon amount of original proof gallons of newly distilled bourbon whiskey, subject to certain annual adjustments. For the contract year ended December 31, 2015, the Company contracted and purchased approximately $1,643,000 in newly distilled bourbon. The Company is not obligated to pay the distiller for any product not yet received. During the term of this supply agreement, the distiller has the right to limit additional purchases to ten percent above the commitment amount.

D. The Company leases office space in New York, NY, Dublin, Ireland and Houston, TX. The New York, NY lease began on May 1, 2010 and expires on April 30, 2016 and provides for monthly payments of $20,375. The Dublin lease commenced on March 1, 2009 and extends through October 31, 2016 and provides for monthly payments of €1,100 or $1,200 (translated at the December 31, 2015 exchange rate). The Houston, TX lease commenced on April 27, 2015 and extends through June 26, 2018 and provides for monthly payments of $3,440. The Company has also entered into non-cancelable operating leases for certain office equipment.

E. As described in Note 7C, in August 2011, the Company and CB-USA entered into the Credit Facility, as amended in July 2012, March 2013, August 2013, November 2013, August 2014, September 2014 and August 2015.

F. The Company believes that neither it nor any of its subsidiaries is currently subject to litigation which, in the opinion of management after consultation with counsel, is likely to have a material adverse effect on the Company.

The Company may become involved in litigation from time to time relating to claims arising in the ordinary course of its business. These claims, even if not meritorious, could result in the expenditure of significant financial and

managerial resources.

NOTE 13 — CONCENTRATIONS

A. Credit Risk — The Company maintains its cash and cash equivalents balances at various large financial institutions that, at times, may exceed federally and internationally insured limits. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk.

B. Customers — Sales to one customer, the Southern Wine and Spirits of America, Inc. family of companies ("SWS"), accounted for approximately 26.5% and 32.6% of the Company's revenues for the three months ended December 31, 2015 and 2014, respectively. Sales to SWS accounted for approximately 29.4% and 29.6% of the Company's revenues for the nine months ended December 31, 2015 and 2014, respectively, and approximately 28.1% of accounts receivable at December 31, 2015.

CASTLE BRANDS INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements - Continued

NOTE 14 — GEOGRAPHIC INFORMATION

The Company operates in one reportable segment — the sale of premium beverage alcohol. The Company's product categories are rum, whiskey, liqueurs, vodka, tequila and related non-alcoholic beverage products. The Company reports its operations in two geographic areas: International and United States.

The consolidated financial statements include revenues and assets generated in or held in the U.S. and foreign countries. The following table sets forth the amounts and percentage of consolidated sales, net, consolidated income (loss) from operations, consolidated net income (loss) attributable to controlling interests, consolidated income tax expense and consolidated assets from the U.S. and foreign countries and consolidated sales, net by category.

	Three Months ended December 31,			
	2015		2014	
Consolidated Sales, net:				
International	$3,738,064	21.7 %	$2,630,784	16.5 %
United States	13,469,308	78.3 %	13,305,730	83.5 %
Total Consolidated Sales, net	$17,207,372	100.0%	$15,936,514	100.0%
Consolidated Income (Loss) from Operations:				
International	$(30,627)	(31.6)%	$870	0.6 %
United States	127,489	131.6%	155,994	99.4 %
Total Consolidated Income (Loss) from Operations	$96,862	100.0%	$156,864	100.0%
Consolidated Net Loss Attributable to Controlling Interests:				
International	$(23,269)	2.9 %	$(14,173)	2.4 %
United States	(784,434)	97.1 %	(576,823)	97.6 %
Total Consolidated Net Loss Attributable to Controlling Interests	$(807,703)	100.0%	$(590,996)	100.0%
Income tax expense, net:				
United States	(383,962)	100.0%	(258,962)	100.0%
Consolidated Sales, net by category:				

Whiskey	$6,686,512	38.9 %	$7,130,948	44.7 %
Rum	4,625,872	26.9 %	3,292,618	20.7 %
Liqueur	1,942,976	11.3 %	2,585,214	16.3 %
Vodka	483,086	2.8 %	622,157	3.9 %
Tequila	24,451	0.1 %	55,237	0.3 %
Related Non-Alcoholic Beverage Products	3,444,475	20.0 %	2,250,340	14.1 %
Total Consolidated Sales, net	$17,207,372	100.0%	$15,936,514	100.0%

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CASTLE BRANDS INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements - Continued

	Nine months ended December 31,			
	2015		2014	
Consolidated Sales, net:				
International	$7,536,028	14.4 %	$6,084,118	14.7 %
United States	44,720,932	85.6 %	35,216,299	85.3 %
Total Consolidated Sales, net	$52,256,960	100.0%	$41,300,417	100.0%
Consolidated Income (Loss) from Operations:				
International	$6,405	2.4 %	$(54,613)	8.3 %
United States	262,267	97.6 %	(600,249)	91.7 %
Total Consolidated Income (Loss) from Operations	$268,672	100.0%	$(654,862)	100.0%
Consolidated Net Income (Loss) Attributable to Controlling Interests:				
International	$31,187	(1.1)%	$(155,372)	4.9 %
United States	(2,973,823)	101.1%	(3,011,968)	95.1 %
Total Consolidated Net Loss Attributable to Controlling Interests	(2,942,636)	100.0%	$(3,167,340)	100.0%
Income tax expense, net:				
United States	(1,487,886)	100.0%	(681,886)	100.0%
Consolidated Sales, net by category:				
Whiskey	$18,319,766	35.0 %	$13,282,260	32.2 %
Rum	14,016,651	26.8 %	11,871,131	28.7 %
Liqueur	6,683,801	12.8 %	6,963,682	16.9 %
Vodka	1,613,626	3.1 %	1,782,560	4.3 %
Tequila	148,487	0.3 %	182,451	0.4 %
Related Non-Alcoholic Beverage Products	11,474,629	22.0 %	7,218,333	17.5 %
Total Consolidated Sales, net	$52,256,960	100.0%	$41,300,417	100.0%

	As of December 31, 2015		As of March 31, 2015	
Consolidated Assets:				
International	$2,329,938	4.7 %	2,052,583	4.7 %
United States	46,739,350	95.3 %	41,986,357	95.3 %

Total Consolidated Assets	$49,069,288	100.0%	44,038,940	100.0%

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

Overview

We develop and market premium and super premium brands in the following beverage alcohol categories: rum, whiskey, liqueurs, vodka and tequila. We distribute our products in all 50 U.S. states and the District of Columbia, in thirteen primary international markets, including Ireland, Great Britain, Northern Ireland, Germany, Canada, Israel, Bulgaria, France, Finland, Norway, Sweden, Denmark, China and the Duty Free markets, and in a number of other countries. We market the following brands, among others:

- Gosling's rum®
- Gosling's Stormy Ginger Beer
- Gosling's Dark 'n Stormy® ready-to-drink cocktail
- Jefferson's® bourbon
- Jefferson's Reserve®
- Jefferson's Ocean Aged at Sea®
- Jefferson's The Manhattan: Barrel Finished Cocktail
- Jefferson's Chef's Collaboration
- Jefferson's Reserve Groth Cask Finish
- Jefferson's Presidential Select™
- Jefferson's Rye whiskey
- Pallini® liqueurs
- Clontarf® Irish whiskey
- Knappogue Castle Whiskey®
- Brady's® Irish Cream
- Boru® vodka
- Tierras™ tequila
- Celtic Honey® liqueur
- Castello Mio® sambuca
- Gozio® amaretto

Our objective is to continue building Castle Brands into a profitable international spirits company, with a distinctive portfolio of premium and super premium spirits brands. To achieve this, we continue to seek to:

- ***focus on our more profitable brands and markets.*** We continue to focus our distribution efforts, sales expertise and targeted marketing activities on our more profitable brands and markets;
- ***grow organically.*** We believe that continued organic growth will enable us to achieve long-term profitability. We focus on brands that have profitable growth potential and staying power, such as our rums and whiskies, sales of

which have grown approximately 46% over the past two fiscal years;

- ***build consumer awareness.*** We use our existing assets, expertise and resources to build consumer awareness and market penetration for our brands;
- ***leverage our distribution network.*** Our established distribution network in all 50 U.S. states enables us to promote our brands nationally and makes us an attractive strategic partner for smaller companies seeking U.S. distribution; and
- ***selectively add new brand extensions and brands to our portfolio.*** We intend to continue to introduce new brand extensions and expressions. For example, we have leveraged our successful Jefferson's portfolio by introducing a number of brand extensions. We continue to explore strategic relationships, joint ventures and acquisitions to selectively expand our premium spirits portfolio. We expect that future acquisitions or agency relationships, if any, would involve some combination of cash, debt and the issuance of our stock.

Recent developments

Pallini Agreement Extension and Amendment

In October 2015, we, through a wholly-owned subsidiary, entered into an extension and amendment agreement ("New Agreement") with Pallini S.p.A. (f/k/a Pallini Internazionale S.r.l.) ("Pallini"), regarding the importation and distribution of certain Pallini brand products. The New Agreement amends the Agreement dated as of January 12, 2011 between Pallini and us ("Original Agreement"), as amended. The terms of the New Agreement are effective as of April 1, 2016.

The New Agreement expires on March 31, 2021, subject to successive five-year renewal periods unless either party delivers a notice of non-renewal six months prior to the end of the term. The Original Agreement had an expiration date of March 31, 2016. Under the New Agreement, if minimum shipment targets are not achieved and not cured, Pallini has the right to terminate the agreement without payment of termination fees to us. The New Agreement also granted us the right to distribute the following additional products: Maraschino Pallini and Ferro China Baliva.

Currency Translation

The functional currencies for our foreign operations are the Euro in Ireland and the British Pound in the United Kingdom. With respect to our consolidated financial statements, the translation from the applicable foreign currencies to U.S. Dollars is performed for balance sheet accounts using exchange rates in effect at the balance sheet date and for revenue and expense accounts using a weighted average exchange rate during the period. The resulting translation adjustments are recorded as a component of other comprehensive income.

Where in this report we refer to amounts in Euros or British Pounds, we have for your convenience also in certain cases provided a conversion of those amounts to U.S. Dollars in parentheses. Where the numbers refer to a specific balance sheet account date or financial statement account period, we have used the exchange rate that was used to perform the conversions in connection with the applicable financial statement. In all other instances, unless otherwise indicated, the conversions have been made using the exchange rates as of December 31, 2015, each as calculated from the Interbank exchange rates as reported by Oanda.com. On December 31, 2015, the exchange rate of the Euro and the British Pound in exchange for U.S. Dollars was €1.00 = U.S. $1.0907 (equivalent to U.S. $1.00 = €0.9168) and £1.00 = U.S. $1.4802 (equivalent to U.S. $1.00 = £0.6755).

These conversions should not be construed as representations that the Euro and British Pound amounts actually represent U.S. Dollar amounts or could be converted into U.S. Dollars at the rates indicated.

Critical Accounting Policies

There are no material changes from the critical accounting policies set forth in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our annual report on Form 10-K for the year ended March 31, 2015, as amended, which we refer to as our 2015 Annual Report. Please refer to that section for disclosures regarding the critical accounting policies related to our business.

Financial performance overview

The following table provides information regarding our spirits case sales for the periods presented based on nine-liter equivalent cases, which is a standard spirits industry metric (table excludes related non-alcoholic beverage products):

	Three months ended December 31,				Nine months ended December 31,			
	2015		2014		2015		2014	
Cases								
United States	72,320		79,015		241,659		221,502	
International	32,560		22,587		70,158		61,196	
Total	104,880		101,602		311,817		282,698	
Rum	42,919		32,464		135,595		117,122	
Whiskey	30,209		29,612		77,607		61,138	
Liqueur	22,431		27,096		67,728		69,480	
Vodka	9,183		12,124		30,122		33,980	
Tequila	138		306		765		964	
Other Spirits	—		—		—		14	
Total	104,880		101,602		311,817		282,698	
Percentage of Cases								
United States	69.0	%	77.8	%	77.5	%	78.4	%
International	31.0	%	22.2	%	22.5	%	21.6	%
Total	100.0	%	100.0	%	100.0	%	100.0	%
Rum	40.9	%	32.0	%	43.5	%	41.4	%
Whiskey	28.8	%	29.1	%	24.9	%	21.6	%
Liqueur	21.4	%	26.7	%	21.7	%	24.6	%
Vodka	8.8	%	11.9	%	9.7	%	12.0	%
Tequila	0.1	%	0.3	%	0.2	%	0.4	%
Other Spirits	0.0	%	0.0	%	0.0	%	0.0	%
Total	100.0	%	100.0	%	100.0	%	100.0	%

The following table provides information regarding our case sales of related non-alcoholic beverage products, which primarily consists of Gosling's Stormy Ginger Beer, for the periods presented:

	Three months ended December 31,		Nine months ended December 31,	
	2015	2014	2015	2014
Cases				
United States	221,585	153,531	756,521	491,888
International	15,408	9,128	33,621	25,252
Total	236,993	162,659	790,142	517,140
Percentage of Cases				
United States	93.5 %	94.4 %	95.7 %	95.1 %
International	6.5 %	5.6 %	4.3 %	4.9 %
Total	100.0 %	100.0 %	100.0 %	100.0 %

Results of operations

The table below provides, for the periods indicated, the percentage of net sales of certain items in our consolidated financial statements:

	Three months ended December 31,		Nine months ended December 31,	
	2015	2014	2015	2014
Sales, net	100.0 %	100.0 %	100.0 %	100.0 %
Cost of sales	61.1 %	62.4 %	61.0 %	62.7 %
Gross profit	38.9 %	37.6 %	39.0 %	37.3 %
Selling expense	26.7 %	25.3 %	26.7 %	26.3 %
General and administrative expense	10.2 %	9.8 %	10.5 %	11.0 %
Depreciation and amortization	1.4 %	1.5 %	1.3 %	1.6 %
Income (loss) from operations	0.6 %	1.0 %	0.5 %	(1.6)%
Other income (expense), net	0.0 %	0.0 %	0.0 %	0.0 %
Foreign exchange (loss) gain	(0.2)%	0.4 %	(0.3)%	(0.5)%
Interest expense, net	(1.6)%	(1.7)%	(1.4)%	(2.0)%

Income from equity investment in non-consolidated affiliate	0.0	%	0.0	%	0.0	%	0.0	%
Loss before provision for income taxes	(1.2	)%	(0.3	)%	(1.2	)%	(4.1	)%
Income tax expense, net	(2.2	)%	(1.6	)%	(2.8	)%	(1.7	)%
Net loss	(3.4	)%	(1.9	)%	(4.0	)%	(5.8	)%
Net income attributable to noncontrolling interests	(1.2	)%	(1.8	)%	(1.6	)%	(1.9	)%
Net loss attributable to common shareholders	(4.6	)%	(3.7	)%	(5.6	)%	(7.7	)%

The following is a reconciliation of net loss attributable to common shareholders to EBITDA, as adjusted:

	Three months ended December 31,		Nine months ended December 31,	
	2015	2014	2015	2014
Net loss attributable to common shareholders	$(807,703)	$(590,996)	$(2,942,636)	$(3,167,340)
Adjustments:				
Interest expense, net	271,677	267,459	786,477	844,316
Income tax expense, net	383,962	258,962	1,487,886	681,886
Depreciation and amortization	235,250	237,652	696,575	669,623
EBITDA income (loss)	83,186	173,077	28,302	(971,515)
Allowance for doubtful accounts	9,000	9,000	52,000	77,000
Allowance for obsolete inventory	—	—	100,000	—
Stock-based compensation expense	338,023	206,553	1,036,412	606,817
Other (income) expense, net	—	208	221	(16,798)
Income from equity investments in non-consolidated affiliate	(4,500)	—	(9,013)	—
Foreign exchange loss (gain)	41,634	(57,879)	131,213	207,579
Net income attributable to noncontrolling interests	211,792	279,110	814,524	795,495
EBITDA, as adjusted	679,135	610,069	2,153,659	698,578

Earnings before interest, taxes, depreciation and amortization, or EBITDA, adjusted for allowances for doubtful accounts and obsolete inventory, stock-based compensation expense, other (income) expense, net, income from equity investment in non-consolidated affiliate, foreign exchange loss and net income attributable to noncontrolling interests is a key metric we use in evaluating our financial performance. EBITDA, as adjusted, is considered a non-GAAP financial measure as defined by Regulation G promulgated by the SEC under the Securities Act of 1933, as amended. We consider EBITDA, as adjusted, important in evaluating our performance on a consistent basis across various periods. Due to the significance of non-cash and non-recurring items, EBITDA, as adjusted, enables our Board of Directors and management to monitor and evaluate the business on a consistent basis. We use EBITDA, as adjusted, as a primary measure, among others, to analyze and evaluate financial and strategic planning decisions regarding future operating investments and allocation of capital resources. We believe that EBITDA, as adjusted, eliminates items that are not indicative of our core operating performance or are based on management's estimates, such as allowance accounts, are due to changes in valuation, such as the effects of changes in foreign exchange, or do not involve a cash outlay, such as stock-based compensation expense. Our presentation of EBITDA, as adjusted, should not be construed as an inference that our future results will be unaffected by unusual or non-recurring items or by non-cash items, such as stock-based compensation, which is expected to remain a key element in our long-term incentive compensation program. EBITDA, as adjusted, should be considered in addition to, rather than as a substitute for, income from operations, net income and cash flows from operating activities.

Our EBITDA, as adjusted, improved to $0.7 million for the three months ended December 31, 2015, as compared to $0.6 million for the comparable prior-year period, primarily as a result of increased sales and gross profit. Our EBITDA, as adjusted, improved to $2.2 million for the nine months ended December 31, 2015, as compared to $0.7 million for the comparable prior-year period, primarily as a result of increased sales and gross profit.

Three months ended December 31, 2015 compared with three months ended December 31, 2014

Net sales. Net sales increased 8.0% to $17.2 million for the three months ended December 31, 2015, as compared to $15.9 million for the comparable prior-year period, due to the overall growth of our Gosling's rum and Gosling's Stormy Ginger Beer. Our international spirits case sales as a percentage of total spirits case sales increased to 31.0% for the three months ended December 31, 2015 as compared to 22.2% for the comparable prior-year period, primarily due to the timing of shipments of rum to our international wholesaler. Our overall spirits sales volume for the three months ended December 31, 2015 was negatively impacted by decreases in sales of our liqueurs portfolio, primarily Pallini, and our vodka, in both instances primarily in the U.S. Also, for the three months ended December 31, 2015, sales of our Gosling's Stormy Ginger Beer increased by 74,334 cases, or 45.7%, overall, including a 68,054 case increase, or 44.3%, in U.S. case sales as compared to the comparable prior-year period. We anticipate continued growth of Gosling's Stormy Ginger Beer in the near term, although there is no assurance that we will attain such results. We continue to focus on our faster growing brands and markets, both in the U.S. and internationally.

The table below presents the increase or decrease, as applicable, in case sales by spirits product category for the three months ended December 31, 2015 as compared to the three months ended December 31, 2014:

	Increase/(decrease) in case sales		Percentage increase/(decrease)	
	Overall	U.S.	Overall	U.S.
Rum	10,455	1,331	32.2 %	5.9 %
Whiskey	597	(567)	2.0 %	(3.1)%
Liqueur	(4,665)	(4,818)	(17.2)%	(17.8)%
Vodka	(2,941)	(2,473)	(24.3)%	(23.7)%
Tequila	(168)	(168)	(55.0)%	(55.0)%
Other spirits	—	—	0.0 %	0.0 %
Total	3,278	(6,695)	3.2 %	(8.5)%

The following table presents the increase in case sales of related non-alcoholic beverage products for the three months ended December 31, 2015 as compared to the three months ended December 31, 2014:

	Increase in case sales		Percentage increase	
	Overall	U.S.	Overall	U.S.
Related Non-Alcoholic Beverage Products	74,334	68,054	45.7%	44.3%

Gross profit. Gross profit increased 11.8% to $6.7 million for the three months ended December 31, 2015 from $6.0 million for the comparable prior-year period, and our gross margin increased to 38.9% for the three months ended December 31, 2015 as compared to 37.6% for the comparable prior-year period. The increase in gross profit was primarily due to increased sales volume and revenue in the current period, while the gross margin increased due to increased sales of our more profitable brands and our ability to take price increases on certain items, partially offset by the increased sales of our lower margin Gosling's Stormy Ginger Beer.

Selling expense. Selling expense increased 14.5% to $4.6 million for the three months ended December 31, 2015 from $4.0 million for the comparable prior-year period, primarily due to a $0.3 million increase in advertising, marketing and promotion expense related to increased sales volume and the timing of certain sales and marketing programs, including the 35th America's Cup sponsorship, and a $0.3 million increase in employee costs, partially offset by $0.1 million decrease in shipping expense. Selling expense as a percentage of net sales increased to 26.7% for the three months ended December 31, 2015 as compared to 25.3% for the comparable prior-year period.

General and administrative expense. General and administrative expense increased 11.9% to $1.8 million for the three months ended December 31, 2015 from $1.6 million for the comparable prior-year period, primarily due to a $0.1 million increase in each of professional fees, and employee expense, with professional fees increasing due to us becoming an accelerated filer. General and administrative expense as a percentage of net sales increased to 10.2% for the three months ended December 31, 2015 as compared to 9.8% for the comparable prior-year period. As a result of our becoming an accelerated filer, we expect general and administrative expense to increase in the near term due to the costs and fees associated with the additional regulatory requirements.

Depreciation and amortization. Depreciation and amortization was $0.2 million for each of the three-month periods ended December 31, 2015 and 2014.

Income (loss) from operations. As a result of the foregoing, income from operations decreased to $0.1 million for the three months ended December 31, 2015 from $0.2 million for the comparable prior-year period. As a result of our focus on our stronger growth markets and better performing brands, and expected growth from our existing brands, we anticipate improved results of operations in the near term as compared to comparable prior-year periods, although there is no assurance that we will attain such results.

Income tax expense, net. Income tax expense, net is the estimated tax expense attributable to the net taxable income recorded by our 60% owned subsidiary, Gosling-Castle Partners, Inc. (“GCP”), adjusted for changes in the deferred tax asset and deferred tax liability during the periods, and was net expense of ($0.4) million for the three months ended December 31, 2015 as compared to net expense of ($0.3) million for the comparable prior-year period.

Foreign exchange loss. Foreign exchange loss for the three months ended December 31, 2015 was ($0.04) million as compared to a gain of $0.06 million for the comparable prior-year period due to the net effects of fluctuations of the U.S. dollar against the Euro and its impact on our Euro-denominated intercompany balances due to our foreign subsidiaries for inventory purchases.

Interest expense, net. We had interest expense, net of ($0.3) million for each of the three-month periods ended December 31, 2015 and 2014 due to balances outstanding under our credit facilities. Due to expected borrowings under credit facilities to finance additional purchases of aged whiskies in support of the growth of our Jefferson’s bourbons and other working capital needs, we expect interest expense, net to increase in the near term as compared to comparable prior-year periods.

Net income attributable to noncontrolling interests. Net income attributable to noncontrolling interests was $0.2 million for the three months ended December 31, 2015 as compared to $0.3 million for the comparable prior-year period, both the result of allocated net income recorded by our 60% owned subsidiary, GCP.

Net loss attributable to common shareholders. As a result of the net effects of the foregoing, net loss attributable to common shareholders decreased to ($0.8) million for the three months ended December 31, 2015 as compared to a loss of ($0.6) million for the comparable prior-year period. Net loss per common share, basic and diluted, was ($0.01) per share for the three months ended December 31, 2015 as compared to ($0.00) for the comparable prior year period.

Nine months ended December 31, 2015 compared with nine months ended December 31, 2014

Net sales. Net sales increased 26.5% to $52.3 million for the nine months ended December 31, 2015, as compared to $41.3 million for the comparable prior-year period, due to the overall growth of our Jefferson's portfolio and our Gosling's rum and Gosling's Stormy Ginger Beer. Our international spirits case sales as a percentage of total spirits case sales increased to 22.5% for the nine months ended December 31, 2015 as compared to 21.6% for the comparable prior-year period, primarily due to the timing of shipments of rum to our international wholesaler. Our overall spirits sales volume for the nine months ended December 31, 2015 was positively impacted by increases in sales of our Jefferson's, Jefferson's Reserve and Jefferson's Ocean Aged at Sea bourbons, and partially offset by decreases in sales of our liqueurs portfolio, primarily Pallini, and our vodka, in both instances primarily in the U.S. Also, for the nine months ended December 31, 2015, sales of our Gosling's Stormy Ginger Beer increased by 273,373 cases, or 52.9%, overall, in the U.S. including a 265,004 case increase, or 53.9%, in U.S. case sales as compared to the comparable prior-year period. We anticipate continued growth of Gosling's Stormy Ginger Beer in the near term, although there is no assurance that we will attain such results. We continue to focus on our faster growing brands and markets, both in the U.S. and internationally.

The table below presents the increase or decrease, as applicable, in case sales by spirits product category for the nine months ended December 31, 2015 as compared to the nine months ended December 31, 2014:

	Increase/(decrease) in case sales		Percentage increase/(decrease)	
	Overall	U.S.	Overall	U.S.
Rum	18,473	8,765	15.8 %	10.2 %
Whiskey	16,469	16,079	26.9 %	45.1 %
Liqueur	(1,752)	(767)	(2.5)%	(1.1)%
Vodka	(3,858)	(3,707)	(11.4)%	(12.1)%
Tequila	(199)	(199)	(20.6)%	(20.6)%
Other spirits	(14)	(14)	(100.0)%	(100.0)%
Total	29,119	20,157	10.3 %	9.1 %

The following table presents the increase in case sales of related non-alcoholic beverage products for the nine months ended December 31, 2015 as compared to the nine months ended December 31, 2014:

	Increase in case sales		Percentage increase	
	Overall	U.S.	Overall	U.S.
Related Non-Alcoholic Beverage Products	273,002	264,633	52.8%	53.8%

Gross profit. Gross profit increased 32.2% to $20.4 million for the nine months ended December 31, 2015 from $15.4 million for the comparable prior-year period, and our gross margin increased to 39.0% for the nine months ended December 31, 2015 compared to 37.3% for the comparable prior-year period. The increase in gross profit was primarily due to increased sales volume and revenue in the current period, while the increase in gross margin was due to increased sales of our more profitable brands, in particular the Jefferson's bourbons, partially offset by the increased sales of our lower margin Gosling's Stormy Ginger Beer. During the nine months ended December 31, 2015, we recorded a net allowance for obsolete and slow moving inventory of $0.1 million, as compared to $0 for the comparable prior-year period. We recorded this allowance on both raw materials and finished goods, primarily in connection with label and packaging changes made to certain brands, as well as certain cost variances. The net charges have been recorded as an increase to cost of sales in the current period. Net of the allowance for obsolete inventory, our gross margin for the nine months ended December 31, 2015 was 39.2% as compared to 37.3% for the comparable prior-year period.

Selling expense. Selling expense increased 28.0% to $13.9 million for the nine months ended December 31, 2015 from $10.9 million for the comparable prior-year period, primarily due to a $1.9 million increase in advertising, marketing and promotion expense related to increased sales volume and the timing of certain sales and marketing programs, including the 35th America's Cup sponsorship, and a $1.2 million increase in employee costs. The increase in sales resulted in selling expense as a percentage of net sales remaining relatively consistent at 26.7% for the nine months ended December 31, 2015 as compared to 26.3% for the comparable prior-year period.

General and administrative expense. General and administrative expense increased 21.2% to $5.5 million for the nine months ended December 31, 2015 from $4.5 million for the comparable prior-year period, primarily due to a $0.4 million increase in each of professional fees, employee expense and stock-based compensation expense, with professional fees increasing due to us becoming an accelerated filer. The increase in sales resulted in general and administrative expense as a percentage of net sales decreasing to 10.5% for the nine months ended December 31, 2015 as compared to 11.0% for the comparable prior-year period. As a result of our becoming an accelerated filer, we expect general and administrative expense to further increase in the near term due to the costs and fees associated with the additional regulatory requirements.

Depreciation and amortization. Depreciation and amortization was $0.7 million for each of the nine-month periods ended December 31, 2015 and 2014.

Income (loss) from operations. As a result of the foregoing, results from operations improved to income of $0.3 million for the nine months ended December 31, 2015 as compared to a loss of ($0.7) million for the comparable prior-year period. As a result of our focus on our stronger growth markets and better performing brands, and expected growth from our existing brands, we anticipate improved results of operations in the near term as compared to comparable prior-year periods, although there is no assurance that we will attain such results.

Income tax expense, net. Income tax expense, net is the estimated tax expense attributable to the net taxable income recorded by our 60% owned subsidiary, GCP, adjusted for changes in the deferred tax asset and deferred tax liability during the periods, and was net expense of ($1.5) million for the nine months ended December 31, 2015 as compared to net expense of ($0.7) million for the comparable prior-year period.

Foreign exchange loss. Foreign exchange loss for the nine months ended December 31, 2015 was ($0.1) million as compared to a loss of ($0.2) million for the comparable prior-year period due to the net effects of fluctuations of the U.S. dollar against the Euro and its impact on our Euro-denominated intercompany balances due to our foreign subsidiaries for inventory purchases.

Interest expense, net. We had interest expense, net of ($0.8) million for each of the nine-month periods ended December 31, 2015 and 2014 due to balances outstanding under our credit facilities. Due to expected borrowings under credit facilities to finance additional purchases of aged whiskies in support of the growth of our Jefferson’s bourbons and other working capital needs, we expect interest expense, net to increase in the near term as compared to comparable prior-year periods.

Net income attributable to noncontrolling interests. Net income attributable to noncontrolling interests was ($0.8) million for each of the nine-month periods ended December 31, 2015 and 2014, both the result of allocated net income recorded by our 60% owned subsidiary, GCP.

Net loss attributable to common shareholders. As a result of the net effects of the foregoing, net loss attributable to common shareholders improved to ($2.9) million for the nine months ended December 31, 2015 as compared to ($3.2) million for the comparable prior-year period. Net loss per common share, basic and diluted, was ($0.02) per share for each of the nine-month periods ended December 31, 2015 and 2014.

Liquidity and capital resources

Overview

Since our inception, we have incurred significant operating and net losses and have not generated cumulative positive cash flows from operations. For the nine months ended December 31, 2015, we had a net loss of $2.1 million, while cash used in operating activities was $4,000. As of December 31, 2015, we had cash and cash equivalents of $1.9 million and had an accumulated deficit of $146.3 million.

We believe our current cash and working capital, the availability under the Credit Facility (as defined below) and additional funds that may be raised in an at-the-market offering under our 2014 equity distribution agreement (the “2014 Distribution Agreement”) will enable us to fund our losses until we achieve profitability, ensure continuity of supply of our brands, and support new brand initiatives and marketing programs through at least December 2016.

Existing Financing

In August 2011, we and our wholly-owned subsidiary Castle Brands (USA) Corp. (“CB-USA”) entered into a loan agreement, which provides for availability (subject to certain terms and conditions) of a facility (the “Credit Facility”) to provide us with working capital, including capital to finance purchases of aged whiskies in support of the growth of our Jefferson’s bourbons.

In September 2014, we entered into an Amended and Restated Loan and Security Agreement (as amended, the “Loan Agreement”) with ACF FinCo I LP (“ACF”), pursuant to which the Credit Facility was amended to modify certain aspects, including increasing the maximum amount of the Credit Facility from $8.0 million to $12.0 million and increasing the inventory sub-limit from $4.0 million to $6.0 million. In addition, the term of the Credit Facility was extended from December 31, 2016 to July 31, 2019 (the “Maturity Date”). The monthly facility fee was reduced from 1.00% per annum of the maximum Credit Facility amount to 0.75%. The Loan Agreement also modified certain aspects of the EBITDA covenant that was contained in the previously existing loan and security agreement, dated as of August 19, 2011, as amended. We paid ACF an aggregate $120,000 amendment fee in connection with the execution of the Loan Agreement.

In August 2015, we entered into a First Amendment (the “Loan Agreement Amendment”) to the Loan Agreement. Among other changes, the Loan Agreement Amendment increased the amount of the Credit Facility from $12.0 million to $19.0 million, including a sublimit in the maximum principal amount of $7.0 million to permit us to acquire aged whiskey inventory (the “Purchased Inventory Sublimit”) subject to certain conditions set forth in the Loan Agreement. The maturity date remained unchanged at July 31, 2019. Pursuant to the Loan Agreement Amendment, we and CB-USA may borrow up to the lesser of (x) $19.0 million and (y) the sum of the borrowing base calculated in

accordance with the Loan Agreement and the Purchased Inventory Sublimit. We and CB-USA may prepay the Credit Facility in whole or the Purchased Inventory Sublimit, in whole or in part, subject to certain prepayment penalties as set forth in the Loan Agreement Amendment. The Purchased Inventory Sublimit replaces our bourbon term loan (the "Bourbon Term Loan"), which was paid in full in the normal course of business. The monthly facility fee remains 0.75% per annum of the maximum principal amount of the Credit Facility (excluding the Purchased Inventory Sublimit). Also, we must pay a monthly facility fee of $2,000 with respect to the Purchased Inventory Sublimit until all obligations with respect thereof are fully paid and performed. We paid ACF an aggregate $45,000 commitment fee in connection with the Loan Agreement Amendment.

In connection with the Loan Agreement Amendment, we entered into the following ancillary agreements: (i) a Reaffirmation Agreement with (a) certain of our officers, including John Glover, our Chief Operating Officer, T. Kelley Spillane, our Senior Vice President - Global Sales, and Alfred J. Small, our Senior Vice President, Chief Financial Officer, Treasurer & Secretary and (b) certain junior lenders of ours, including Frost Gamma Investments Trust, an entity affiliated with Phillip Frost, M.D., a director of ours and a principal shareholder of ours, Mark E. Andrews, III, a director of ours and our Chairman, an affiliate of Richard J. Lampen, a director of ours and our President and Chief Executive Officer, an affiliate of Glenn Halpryn, a director of ours, Dennis Scholl, a former director of ours, and Vector Group Ltd., a more than 5% shareholder of ours, of which Richard Lampen is an executive officer, Henry Beinstein, a director of ours, is a director and Phillip Frost, M.D. is a principal shareholder, which, among other things, reaffirms the existing Validity and Support Agreements by and among each officer, us and ACF and (ii) an Amended and Restated Revolving Credit Note.

ACF also required as a condition to entering into the Loan Agreement Amendment that ACF enter into a participation agreement with certain related parties of ours, including Frost Gamma Investments Trust ($150,000), Mark E. Andrews, III ($50,000), Richard J. Lampen ($100,000), and Alfred J. Small ($15,000), to allow for the sale of participation interests in the Purchased Inventory Sublimit and the inventory purchased with the proceeds thereof. The participation agreement provides that ACF's commitment to fund each advance of the Purchased Inventory Sublimit shall be limited to seventy percent (70%), up to an aggregate maximum principal amount for all advances equal to $4.9 million. Under the terms of the participation agreement, the participants receive interest at the rate of 11% per annum. We are not a party to the participation agreement. However, we and CB-USA are party to a fee letter with the junior participants (including the related party junior participants) pursuant to which we and CB-USA were obligated to pay the junior participants a closing fee of $18,000 on the effective date of the Loan Agreement Amendment and are obligated to pay a commitment fee of $18,000 on each anniversary of the effective date until the junior participants' obligations are terminated pursuant to the participation agreement.

We may borrow up to the maximum amount of the Credit Facility, provided that we have a sufficient borrowing base (as defined in the Loan Agreement). The Credit Facility interest rate (other than with respect to the Purchased Inventory Sublimit) is the rate that, when annualized, is the greatest of (a) the Prime Rate plus 3.00%, (b) the LIBOR Rate plus 5.50% and (c) 6.0%. The interest rate applicable to the Purchased Inventory Sublimit is the rate, that when annualized, is the greatest of (a) the Prime Rate plus 4.25%, (b) the LIBOR Rate plus 6.75% and (c) 7.50%. Interest is payable monthly in arrears, on the first day of every month on the average daily unpaid principal amount of the Credit Facility. After the occurrence and during the continuance of any “Default” or “Event of Default” (as defined under the Loan Agreement) we are required to pay interest at a rate that is 3.25% per annum above the then applicable Credit Facility interest rate. The Loan Agreement contains EBITDA targets allowing for further interest rate reductions in the future. The Credit Facility currently bears interest at 6.0% and the Purchased Inventory Sublimit currently bears interest at 7.50%. We are required to pay down the principal balance of the Purchased Inventory Sublimit within 15 banking days from the completion of a bottling run of bourbon from our bourbon inventory stock purchased with funds borrowed under the Purchased Inventory Sublimit in an amount equal to the purchase price of such bourbon. The unpaid principal balance of the Credit Facility all accrued and unpaid interest thereon, and all fees, costs and expenses payable in connection with the Credit Facility, are due and payable in full on the Maturity Date. In addition to closing fees, ACF receives facility fees and a collateral management fee (each as set forth in the Loan Agreement). Our obligations under the Loan Agreement are secured by the grant of a pledge and a security interest in all of our assets.

The Loan Agreement contains standard borrower representations and warranties for asset-based borrowing and a number of reporting obligations and affirmative and negative covenants. The Loan Agreement includes negative covenants that, among other things, restrict our ability to create additional indebtedness, dispose of properties, incur liens, and make distributions or cash dividends. At December 31, 2015, we were in compliance with the covenants under the Loan Agreement.

In December 2009, GCP, a 60% owned subsidiary, issued a promissory note in the aggregate principal amount of $0.2 million to Gosling’s Export (Bermuda) Limited in exchange for credits issued on certain inventory purchases. This note matures on April 1, 2020, is payable at maturity, subject to certain acceleration events, and calls for annual interest of 5%, to be accrued and paid at maturity.

We have arranged various credit facilities aggregating €0.3 million or $0.3 million (translated at the December 31, 2015 exchange rate) with an Irish bank, including overdraft coverage, creditors’ insurance, customs and excise guaranty, and a revolving credit facility. These facilities are payable on demand, continue until terminated by either party, are subject to annual review, and call for interest at the lender’s AA1 Rate minus 1.70%. We have deposited €0.3 million or $0.3 million (translated at the December 31, 2015 exchange rate) with the bank to secure these borrowings. We are in compliance in all material respects with the covenants of our Irish bank facilities as of December 31, 2015.

In October 2013, we issued an aggregate principal amount of $2.1 million unsecured 5% convertible subordinated notes (the “Convertible Notes”). We used a portion of the proceeds to finance the acquisition of additional bourbon

inventory in support of the growth of our Jefferson's bourbon brand.

The Convertible Notes bear interest at a rate of 5% per annum and mature on December 15, 2018. The Convertible Notes and accrued but unpaid interest thereon are convertible in whole or in part from time to time at the option of the holders thereof into shares of our common stock, par value $0.01 per share ("Common Stock"), at a conversion price of $0.90 per share (the "Conversion Price"). The Convertible Notes may be prepaid in whole or in part at any time without penalty or premium, but with payment of accrued interest to the date of prepayment. The Convertible Notes contain customary events of default, which, if uncured, entitle each noteholder to accelerate the due date of the unpaid principal amount of, and all accrued and unpaid interest on, the Convertible Notes. The Convertible Note purchasers included certain related parties of ours, including an affiliate of Dr. Phillip Frost ($500,000), Mark E. Andrews, III ($50,000), an affiliate of Richard J. Lampen ($50,000), an affiliate of Glenn Halpryn ($200,000), Dennis Scholl ($100,000) and Vector Group Ltd. ($200,000).

In November 2014, we entered into the 2014 Distribution Agreement with Barrington Research Associates, Inc. ("Barrington") as sales agent, under which we may issue and sell over time and from time to time, to or through Barrington, shares (the "Shares") of our Common Stock having a gross sales price of up to $10.0 million. The 2014 Distribution Agreement replaced the prior equity distribution agreement entered into with Barrington in November 2013, under which we could offer and sell Shares of our Common Stock having a gross sale price of up to $6.0 million.

Sales of the Shares pursuant to the 2014 Distribution Agreement may be effected by any method permitted by law deemed to be an "at-the-market" offering as defined in Rule 415 of the Securities Act of 1933, as amended, including without limitation directly on the NYSE MKT LLC or any other existing trading market for the Common Stock or through a market maker, up to the amount specified, and otherwise to or through Barrington in accordance with the placement notices delivered by us to Barrington. Also, with our prior consent, some of the Shares issued pursuant to the 2014 Distribution Agreement may be sold in privately negotiated transactions.

During the nine months ended December 31, 2015, we sold 2,119,282 Shares pursuant to the 2014 Distribution Agreement, with total gross proceeds of $3,251,989, before deducting sales agent and offering expenses of $95,344. We used a portion of the proceeds to finance our investment in Copperhead Distillery Company and intend to use the remaining proceeds for general corporate purposes. As of February 9, 2016, approximately $4.7 million remained available for issuance pursuant to the 2014 Distribution Agreement.

Liquidity Discussion

As of December 31, 2015, we had shareholders' equity of $22.8 million as compared to $21.1 million at March 31, 2015. This increase is primarily due to the net issuance of $3.2 million of Common Stock under the 2014 Distribution Agreement, partially offset by the $2.1 million loss and the $0.6 million subsidiary dividend paid to noncontrolling interests and our total comprehensive loss for the nine months ended December 31, 2015.

We had working capital of $25.9 million at December 31, 2015 as compared to $25.7 million at March 31, 2015. This increase is primarily due to a $6.0 million increase in inventory and a $0.7 million increase in cash and cash equivalents, partially offset by a net $4.6 million increase in accounts payable, accrued expenses and a $1.7 million decrease in accounts receivable.

As of December 31, 2015, we had cash and cash equivalents of approximately $1.9 million, as compared to $1.2 million as of March 31, 2015. The increase is primarily attributable to the equity issued and debt raised, offset by the funding of our operations and working capital needs for the nine months ended December 31, 2015. At December 31, 2015, we also had approximately $0.3 million of cash restricted from withdrawal and held by a bank in Ireland as collateral for overdraft coverage, creditors' insurance, revolving credit and other working capital purposes.

The following may materially affect our liquidity over the near-to-mid term:

- cash losses from operations;
- our ability to obtain additional debt or equity financing should it be required;
- an increase in working capital requirements to finance higher levels of inventories and accounts receivable;
- our ability to maintain and improve our relationships with our distributors and our routes to market;
- our ability to procure raw materials at a favorable price to support our level of sales;
- potential acquisitions; and
- expansion into new markets and within existing markets in the U.S. and internationally.

We continue to implement a plan to support the growth of existing brands through sales and marketing initiatives that we expect will generate cash flows from operations in the next few years. As part of this plan, we seek to grow our business through expansion to new markets, growth in existing markets and strengthened distributor relationships. As our brands continue to grow, our working capital requirements will increase. In particular, the growth of our Jefferson's brands requires a significant amount of working capital relative to our other brands, as we are required to purchase and hold ever increasing amounts of aged bourbon to meet growing demand. While we are seeking solutions to our long-term bourbon supply needs, we are required to purchase and hold several years' worth of aged bourbon in inventory until such time as it is aged to our specific brand taste profiles, increasing our working capital requirements

and negatively impacting cash flows.

We are also seeking additional brands and agency relationships to leverage our existing distribution platform. We intend to finance any such brand acquisitions through a combination of our available cash resources, borrowings and, in appropriate circumstances, additional issuances of equity and/or debt securities. Acquiring additional brands could have a significant effect on our financial position, could materially reduce our liquidity and could cause substantial fluctuations in our quarterly and yearly operating results. We continue to look to control expenses, seek improvements in routes to market and contain production costs to improve cash flows.

As of December 31, 2015, we had borrowed $9.6 million of the $19.0 million available under the Credit Facility, including $2.8 million of the $7.0 million available under the Purchased Inventory Sublimit, leaving $2.4 million in potential availability for working capital needs under the Credit Facility and $4.2 million available for aged whiskey inventory purchases. As of the date of this report, we had borrowed $8.0 million of the $19.0 million available under the Credit Facility, including $2.8 million of the $7.0 million available under the Purchased Inventory Sublimit, leaving $4.0 million in potential availability for working capital needs under the Credit Facility and $4.2 million available for aged whiskey inventory purchases. We believe our current cash and working capital, the availability under the Credit Facility and the additional funds that may be raised under the 2014 Distribution Agreement will enable us to fund our losses until we achieve profitability, ensure continuity of supply of our brands, and support new brand initiatives and marketing programs through at least December 2016.

Cash flows

The following table summarizes our primary sources and uses of cash during the periods presented:

	Nine months ended December 31,	
	2015	2014
	(in thousands)	
Net cash provided by (used in):		
Operating activities	$ (4)	$ (7,597)
Investing activities	(824)	(378)
Financing activities	1,542	7,931
Subtotal	714	(44)
Effect of foreign currency translation	(9)	(10)
Net increase in cash and cash equivalents	$ 705	$ (54)

Operating activities. A substantial portion of available cash has been used to fund our operating activities. In general, these cash funding requirements are based on operating losses, driven chiefly by the costs in maintaining our distribution system and our sales and marketing activities. We have also utilized cash to fund our inventories. In general, these cash outlays for inventories are only partially offset by increases in our accounts payable to our suppliers.

On average, the production cycle for our owned brands is up to three months from the time we obtain the distilled spirits and other materials needed to bottle and package our products to the time we receive products available for sale, in part due to the international nature of our business. We do not produce Gosling's rums or ginger beer, Pallini liqueurs, Tierras tequila, or Gozio amaretto. Instead, we receive the finished product directly from the owners of such brands. From the time we have products available for sale, an additional two to three months may be required before we sell our inventory and collect payment from customers. Further, our inventory at December 31, 2015 included significant additional stores of aged bourbon purchased in advance of forecasted production requirements. We expect to use the aged bourbon in the normal course of future sales, generating positive cash flows in future periods.

During the nine months ended December 31, 2015, net cash used in operating activities was de minimis, consisting primarily of a net loss of $2.1 million, a $6.0 million increase in inventory and a $0.2 million increase in prepaid expenses and supplies. These uses of cash were partially offset by a $4.6 million increase in accounts payable and accrued expense, a $1.7 million decrease in accounts receivable, a $0.1 million increase in due from affiliates, stock based compensation expense of $1.0 million and depreciation and amortization expense of $0.7 million.

During the nine months ended December 31, 2014, net cash used in operating activities was $7.6 million, consisting primarily of a $7.8 million increase in inventory, a net loss of $2.4 million, a $0.2 million increase in other assets and a $0.1 million increase in accounts receivable. These uses of cash were partially offset by a $0.3 million decrease in prepaid expenses, stock based compensation expense of $0.6 million, depreciation and amortization expense of $0.7 million and $0.7 million in income tax expense, net.

Investing Activities. Net cash used in investing activities was $0.8 million for the nine months ended December 31, 2015, representing a $0.5 million investment in Copperhead Distillery and $0.3 million used in the acquisition of fixed and intangible assets.

Net cash used in investing activities was $0.4 million for the nine months ended December 31, 2014, representing $0.4 million used in the acquisition of fixed and intangible assets.

Financing activities. Net cash provided by financing activities for the nine months ended December 31, 2015 was $1.5 million, consisting primarily of $3.2 million in net proceeds from the issuance of Common Stock pursuant to the at-the-market offering and $0.2 million from the exercise of Common Stock options, partially offset by $0.5 million in net payments on the Credit Facility, $0.7 million paid on the Bourbon Term Loan and $0.6 million in dividends paid to non-controlling interests of GCP.

Net cash provided by financing activities for the nine months ended December 31, 2014 was $7.9 million, consisting primarily of $7.5 million in net proceeds from the Keltic Facility, $1.8 million in net proceeds from the issuance of Common Stock pursuant to our distribution agreements with Barrington, $0.6 million in proceeds from the exercise of the Common Stock warrants issued in our 2011 private placement and $0.2 million in proceeds from the exercise of stock options, partially offset by the $1.25 million repayment of the Junior Loan and the $0.9 million paid on the Bourbon Term Loan.

Recent accounting standards issued and adopted.

We discuss recently issued and adopted accounting standards in the “Recent accounting pronouncements” section of Note 1 of the “Notes to Unaudited Consolidated Financial Statements” in the accompanying unaudited consolidated financial statements.

Cautionary Note Regarding Forward Looking Statements

This annual report includes certain “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. These statements, which involve risks and uncertainties, relate to the discussion of our business strategies and our expectations concerning future operations, margins, profitability, liquidity and capital resources and to analyses and other information that are based on forecasts of future results and estimates of amounts not yet determinable. We use words such as “may”, “will”, “should”, “expects”, “intends”, “plans”, “anticipates”, “believes”, “estimate “predicts”, “could”, “projects”, “potential” and similar terms and phrases, including references to assumptions, in this report to identify forward-looking statements. These forward-looking statements are made based on expectations and beliefs concerning future events affecting us and are subject to uncertainties, risks and factors relating to our operations and business environments, all of which are difficult to predict and many of which are beyond our control, that could cause our actual results to differ materially from those matters expressed or implied by these forward-looking statements. These risks and other factors include those listed under “Risk Factors” in our annual report on Form 10-K for the year ended March 31, 2015, as amended, and as follows:

- our history of losses;
- recent worldwide and domestic economic trends and financial market conditions could adversely impact our financial performance;
- our potential need for additional capital, which, if not available on acceptable terms or at all, could restrict our future growth and severely limit our operations;

- our brands could fail to achieve more widespread consumer acceptance, which may limit our growth;

- our dependence on a limited number of suppliers, who may not perform satisfactorily or may end their relationships with us, which could result in lost sales, incurrence of additional costs or lost credibility in the marketplace;
- our annual purchase obligations with certain suppliers;
- the failure of even a few of our independent wholesale distributors to adequately distribute our products within their territories could harm our sales and result in a decline in our results of operations;
- the potential limitation to our growth if we are unable to identify and successfully acquire additional brands that are complementary to our existing portfolio, or integrate such brands after acquisitions;
- currency exchange rate fluctuations and devaluations may significantly adversely affect our revenues, sales, costs of goods and overall financial results;
- our need to maintain a relatively large inventory of our products to support customer delivery requirements, which could negatively impact our operations if such inventory is lost due to theft, fire or other damage;
- the possibility that we or our strategic partners will fail to protect our respective trademarks and trade secrets, which could compromise our competitive position and decrease the value of our brand portfolio;
- the possibility that we cannot secure and maintain listings in control states, which could cause the sales of our products to decrease significantly;
- an impairment in the carrying value of our goodwill or other acquired intangible assets could negatively affect our operating results and shareholders' equity;
- changes in consumer preferences and trends could adversely affect demand for our products;
- there is substantial competition in our industry and the many factors that may prevent us from competing successfully;
- adverse changes in public opinion about alcohol could reduce demand for our products;
- class action or other litigation relating to alcohol misuse or abuse could adversely affect our business; and
- adverse regulatory decisions and legal, regulatory or tax changes could limit our business activities, increase our operating costs and reduce our margins.

We assume no obligation to publicly update or revise these forward-looking statements for any reason, or to update the reasons actual results could differ materially from those anticipated in, or implied by, these forward-looking statements, even if new information becomes available in the future.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk

We are exposed to market risks arising from changes in market rates and prices, including movements in interest rates and foreign currency exchange rates. We do not enter into derivatives or other financial instruments for trading or speculative purposes. In the future, we may enter into financial instruments to manage and reduce the impact of changes in interest rates and foreign currency exchange rates, although we do not currently have any such instruments in place. The following is additional information about the market risks we are exposed to and how we manage these risks:

Interest rate risk

Interest on our Credit Facility (other than with respect to the Purchased Inventory Sublimit) is charged at the rate that, when annualized, is the greatest of (a) the Prime Rate plus 3.00%, (b) the LIBOR Rate plus 5.50% and (c) 6.00%. The interest rate applicable to the Purchased Inventory Sublimit is the rate that, when annualized, is the greatest of (a) the Prime Rate plus 4.25%, (b) the LIBOR Rate plus 6.75% and (c) 7.50%. As of December 31, 2015, we had $9,764,103 outstanding under the Credit Facility, including $2,841,000 under the Purchased Inventory Sublimit, none of which is currently being hedged. Interest on our foreign revolving credit facilities is charged at the lender's AA1 Rate minus 1.70%. As of December 31, 2015, we had €0 outstanding under our foreign revolving credit facilities.

A hypothetical one percentage point (100 basis points) increase in the interest rate being charged on the $9,764,103 of unhedged debt outstanding under our Credit Facility, including the Purchased Inventory Sublimit, and our foreign revolving credit facilities at December 31, 2015 would have an impact of approximately $24,272 on our interest expense for the quarter.

Foreign exchange rate risk

The majority of our sales, net and expenses are transacted in U.S. dollars. However, in the three months ended December 31, 2015, Euro denominated sales accounted for approximately 11.4% of our sales, net. We also incur expenses in foreign currencies, primarily the Euro. In the three months ended December 31, 2015, Euro denominated expenses accounted for approximately 6.5% of our expenses. A substantial change in the rate of exchange between the U.S. dollar and the Euro could have a significant adverse effect on our financial results. A hypothetical 10% change in the value of the U.S. dollar in relation to the Euro and British pound would have had an impact of approximately $195,286 on our loss from operations for the three months ended December 31, 2015.

If we do not enter into hedging arrangements, the more we expand our business outside the United States, the more our financial results will be exposed to exchange rate fluctuations. In the past, we have entered into forward contracts from time to time to reduce our exposure to foreign currency fluctuations. We recognize derivative contracts in the balance sheet at fair value, and reflect any net gains and losses currently in earnings. At December 31 and March 31, 2015, we had no forward contracts outstanding. Gain or loss on foreign currency forward contracts, which was de minimis during the periods presented, is included in other income and expense.

The functional currencies for our foreign operations are the Euro in Ireland and the British Pound in the United Kingdom. With respect to our consolidated financial statements, the translation from the applicable foreign currencies to U.S. Dollars is performed for balance sheet accounts using exchange rates in effect at the balance sheet date and for revenue and expense accounts using a weighted average exchange rate during the period. The resulting translation adjustments are recorded as a component of other comprehensive income. The effect of foreign currency translation was a loss of ($58,872) for the three months ended December 31, 2015 and income of $15,329 for the three months ended December 31, 2014. A hypothetical 10% change in the value of the U.S. dollar in relation to the Euro and British pound would have had an impact of approximately $291,000 for the three months ended December 31, 2015 as a result of foreign currency translation.

Commodity price risk

We currently are not exposed to commodity price risks. We do not purchase the basic ingredients such as grain, sugar cane or agave that are converted into alcohol through distillation. Instead, we have relationships with various companies to provide distillation, bottling or other production services for us. These relationships vary on a brand-by-brand basis.

As of December 31, 2015, we did not have any hedging arrangements in place to protect our exposure to commodity price fluctuations.

Item 4. Controls and Procedures

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Disclosure controls and procedures are our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934, as amended, is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding disclosure.

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we have evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a—15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report, and, based on that evaluation, our principal executive officer and principal financial officer

have concluded that these controls and procedures are effective as of such date.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Rule 13a-15 under the Securities Exchange Act of 1934, as amended, that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Please see Note 12 E. to our unaudited consolidated financial statements elsewhere in this Quarterly Report on Form 10-Q.

Item 6. Exhibits

Exhibit Number	Description
10.1	Extension and Amendment Agreement, dated as of October 24, 2015, by and between Castle Brands (USA) Corp. and Pallini S.p.A. (f/k/a Pallini Internazionale S.r.l.). Certain portions of this agreement have been omitted under a request for confidential treatment pursuant to Rule 24b-2 of the Securities Exchange Act of 1934 and filed separately with the United States Securities and Exchange Commission (incorporated by reference to Exhibit 10.1 to our current report on Form 8-K filed with the SEC on October 29, 2015).
31.1 *	Certification Pursuant to Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2 *	Certification Pursuant to Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1 *	Certification of CEO and CFO Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document.
101.SCH*	XBRL Taxonomy Extension Schema Document.
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document.

* Filed herewith

SIGNATURES

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

CASTLE BRANDS INC.

By: /s/ Alfred J. Small
Alfred J. Small
Chief Financial Officer
(Principal Financial Officer and
Principal Accounting Officer)

February 9, 2016

34

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Developed technologies

$

6,904

$

(5,092

)

$

1,812

$

6,904

$

(4,869

)

$

2,035

Customer list and trade-names

2,731

(2,120

)

611

2,731

(2,041

)

690

$

9,635

$

(7,212

)

$

2,423

$

9,635

$

(6,910

)

$ 2,725

All of the Company's acquired intangible assets are subject to amortization and are carried at cost less accumulated amortization. Amortization is computed on a straight line basis over the estimated useful lives which are as follows: Developed technologies—one and one half to five years; trade-names—three to five years; customer list—three to five years. Aggregate amortization expense for intangible assets totaled $0.3 million for each of the three months ended December 31, 2007 and 2006, respectively. The Company expects amortization expense on acquired intangible assets to be $0.9 million for the remainder of fiscal year 2008, $1.2 million in fiscal year 2009 and $0.3 million in fiscal year 2010.

Other assets

Other assets consist of the following (in thousands):

	December 31, 2007	September 30, 2007
Other assets:		
Long-term accounts receivable	$ —	$ 984
Other assets	2,078	2,280
	$ 2,078	$ 3,264

The long-term accounts receivable balance represents a receivable from a single customer related to a sale transaction that occurred during the quarter ended December 31, 2006. This amount represents the third and final payment which is due in the quarter ending December 2008. All revenue associated with this receivable has been deferred and will not be recognized until the payment becomes due. As of December 31, 2007, the receivable has been recorded as a current accounts receivable.

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CHORDIANT SOFTWARE, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

Accrued expenses

Accrued expenses consist of the following (in thousands):

	December 31, 2007	September 30, 2007
Accrued expenses:		
Accrued payroll, payroll taxes and related expenses	$ 7,842	$ 6,781
Accrued restructuring expenses, current portion (Note 5)	1,721	3,044
Accrued third party consulting fees	724	1,264
Accrued income, sales and other taxes	1,920	1,143
Other accrued liabilities	1,496	1,572
	$ 13,703	$ 13,804

NOTE 5—RESTRUCTURING

Restructuring Costs

Through December 31, 2007,the Company implementedcertain restructuring plans to, among other things, reduce its workforce and consolidate facilities. Restructuring and asset impairment expenses have been recorded to align the Company’s cost structure with changing market conditions and to create a more efficient organization. The Company’s restructuring expenses have been comprised primarily of: (i) severance and termination benefit costs related to the reduction of our workforce; and (ii) lease termination costs and costs associated with permanently vacating certain facilities. The Company accounted for each of these costs in accordance with SFAS No. 146, “Accounting for Costs Associated with Exit or Disposal Activities” or previous guidance under Emerging Issues Task Force 94-3 “Liabilities Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)”, or EITF 94-3.

Retroactive application of SFAS 146 to periods prior to January 1, 2003, was prohibited; accordingly, the accrual relating to facilities vacated prior to the effective date of SFAS 146 continues to be accounted for in accordance with the guidance of EITF 94-3. Accruals for facilities that were restructured prior to 2003 do not reflect any adjustments relating to the estimated net present value of cash flows associated with the facilities.

For each ofthe periods presented herein, restructuring expenses consist solely of:

- Severance and Termination Benefits—These costs represent severance and payroll taxes related to restructuring plans.

- Excess Facilities—These costs represent future minimum lease payments related to excess and abandoned office space under leases, the disposal of property and equipment including facility leasehold improvements, and net of estimated sublease income.

As of December 31, 2007, the total restructuring accrual consisted of the following (in thousands):

	Current	Non-Current	Total
Severance and termination benefits	$ 97	$ —	$ 97
Excess facilities	1,624	837	2,461
Total	$ 1,721	$ 837	$ 2,558

As of December 31, 2007, and September 30, 2007, $1.7 million and $3.0 million related to the restructuring reserve are included in the Accrued Expenses line item on the Condensed Consolidated Balance Sheets, respectively. The allocation between current portion and long-term portion is based on the current lease agreements.

The Company expects the remaining severance and termination benefit accrual to be paid by September 30, 2008.

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The excess facilities reserve relates to two facilities: one located in the United Kingdomand one in Boston, Massachusetts. The Company expects to pay the excess facilities amounts related to the restructured or vacated leased office space as follows (in thousands):

Fiscal Year Ended September 30,	Total Future Minimum Lease Payments
2008 (remaining nine months)	$ 1,519
2009	412
2010	405
2011	125
Total	$ 2,461

Included in the future minimum lease payments schedule above is an offset of $0.8million of contractually committed sublease rental income for the Bostonfacility. In November 2007, the Company negotiated a break clause in the United Kingdomlease allowing for an early termination of the respective facility which will release the Company of any future rent liabilities subsequent to January 2008. The scheduled lease payments shown in the table above reflect apayment of $1.2million in the second quarter of fiscal year 2008 associated with the early termination of the United Kingdomlease. Subsequent to December 31, 2007 and as of the date of the filing of this Form 10-Q, the Company has paid its final lease payment for the United Kingdomlease and has been released from any future rent liabilities.

Fiscal Year 2007 Restructuring

In October 2006, the Company initiated a restructuring plan intended to align its resources and cost structure with expected future revenues. The restructuring plan included a balancing of service resources worldwide, elimination of duplicative functions internationally, and a shift in the U.S.field organization toward a focus on domain–based sales and pre-sales teams. As a result of the restructuring plan, management undertook a reduction of 33 positions or approximately 10% of the Company's workforce and consolidation of the European headquarters in the United Kingdomand the closure of the Franceoffice, or 2007 Restructuring. As part of the 2007 Restructuring, the Company initially incurred a one-time restructuring expenseof $6.5million for severance and termination benefits, and excess facilities expensed to Restructuring Expense in the Condensed Consolidated Statements of Operations. The Company accrued lease costs pertaining to the consolidation of excess facilities relating to lease terminations and non-cancelable lease costs. The Company was able to terminate the Francefacility lease during the year-ended September 30, 2007. In the quarter ended December 31, 2007, the Company negotiated an early termination option for the United Kingdomlease which terminatedthe lease inJanuary 2008. Managementbelieves the current restructure reserve amount is sufficient to meet all payments required as a result of the anticipated early termination.

The following table summarizes the activity related to the 2007 Restructuring(in thousands):

	Excess Facilities
Reserve balance as of September 30, 2007	$ 2,526
Non-cash	(62)
Cash paid	(1,282)

Reserve balance as of December 31, 2007	$	1,182

Fiscal Year 2005 Restructuring

In May 2005, the Company appointed a task force to improve profitability and control expenses. The goal of the task force was to create a better alignment of functions within the Company, to make full utilization of the Company's India development center, to develop a closer relationship between the Company's field operations and customers, to review the sales and implementation models, as well adjust as the organization model to flatten management levels, to review the Company's product line, and to enhance the Company's business model for profitability and operating leverage. This work resulted in an approximate 10% reduction in the Company's workforce, or 2005 Restructuring,and in July 2005 affected employees were notified. As part of the 2005 Restructuring, the Company incurred a one-time restructuring charge of $1.1 million in the fourth quarter ended September 30, 2005 for severance and termination benefits.

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The following table summarizes the activity related to the 2005 Restructuring (in thousands):

	Severance and Termination Benefits
Reserve balance as of September 30, 2007	$ 100
Non-cash	(3)
Cash paid	—
Reserve balance as of December 31, 2007	$ 97

Prior Restructurings

During fiscal year 2002, based upon the Company'scontinued evaluation of economic conditions in the information technology industry and our expectations regarding revenue levels, the Company restructured several areas so as to reduce expenses and improve revenue per employee, or 2002 Restructuring. As part of 2002 Restructuring, the Companyrecorded a total workforce reduction expense relating to severance and termination benefits of approximately $2.0 million and $3.8 million for years ended December 31, 2003 and 2002, respectively. In addition to these costs, the Companyaccrued lease costs related to excess facilities of $0.2 million and $2.8 million during the years ended December 31, 2003 and 2002, respectively, pertaining to the consolidation of excess facilities relating to lease terminations and non-cancelable lease costs. This expense is net of estimated sublease income based on current comparable rates for leases in the respective markets.

During theyear ended September 30, 2007, the Company entered into a new sublease for the last remaining facility lease associated with the 2002 Restructuring. As a result of this sublease rental income being lower than previously estimated as part of the restructure facility reserve, the Company recorded an additional $0.4million of restructuring expense during the year ended September 30, 2007. The sublease term is through the entire remaining term of theCompany's lease obligation for the facility.

The following table summarizes the activity related to the 2002 Restructuring (in thousands):

	Excess Facilities
Reserve balance as of September 30, 2007	$ 1,360
Non-cash	—
Cash paid	(81)
Reserve balance as of December 31, 2007	$ 1,279

NOTE 6—COMPREHENSIVE INCOME (LOSS)

The components of comprehensive income (loss) are as follows (in thousands):

	Three Months Ended December 31,	
	2007	2006

Net income (loss)	$	205	$	(10,749)
Other comprehensive income (loss):				
Change in foreign currency translation		29		452
Net change in unrealized gain from investments		5		—
Comprehensive income (loss)	$	239	$	(10,297)

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NOTE 7—RELATED PARTY TRANSACTIONS

In August 2005, the Company entered into a service provider agreement with Infogain Corporation, or Infogain. Samuel T. Spadafora, aformer director and executive officer of the Company, is a director of Infogain. Mr. Spadafora terminated his relationship with the Company in November 2006.

Charles E. Hoffman, a director of the Company, is the President and Chief Executive Officer of Covad Communications Group, Inc., or Covad, a customer of ours.

The following presents the related party transaction balances (in thousands):

	Revenue		Cost of Revenues		Payments	
	Three Months Ended December 31,					
	2007	2006	2007	2006	2007	2006
Infogain	$ —	$ —	$ —	$ 177	$ —	$ 117
Covad	64	63	—	—	—	—
	$ 64	$ 63	$ —	$ 177	$ —	$ 117

	Deferred Revenue	
	As of December 31, 2007	As of September 30, 2007
Infogain	$ —	$ —
Covad	52	116
	$ 52	$ 116

NOTE 8—BORROWINGS

Revolving line of credit

The Company's revolving line of credit with Comerica Bank was amended and restated on March 8, 2006 and was extended to March 7, 2008. The terms of the agreement include a $5.0 million line of credit, available on a non-formula basis, and require the Company to maintain (i) at least a $5.0 million cash balance in Comerica Bank accounts, (ii) a minimum quick ratio of 2 to 1, (iii) a liquidity ratio of at least 1 to 1 at all times, and (iv) subordinate any debt issuances subsequent to the effective date of the agreement, and certain other covenants. All assets of the Company have been pledged as collateral on the credit facility.

The revolving line of credit contains a provision for a sub-limit of up to $5.0 million for issuances of standby commercial letters of credit. As of December 31, 2007, the Company had utilized $0.3 million of the standby commercial letters of credit limit of which $0.3 million serves as collateral for computer equipment leases for Ness (see Note 9). The revolving line of credit also contains a provision for a sub-limit of up to $3.0 million for issuances of foreign exchange forward contracts. As of December 31, 2007, the Company had not entered into any foreign exchange forward contracts. Pursuant to the amendment in March 2006, the Company is required to secure the standby commercial letters of credit and foreign exchange forward contracts through March 7, 2008. If these have not

been secured to Comerica Bank's satisfaction, the Company's cash and cash equivalent balances held by Comerica Bank automatically secure such obligations to the extent of the then continuing or outstanding and undrawn letters of credit or foreign exchange contracts.

Borrowings under the revolving line of credit bear interest at the lending bank's prime rate. Except for the standby commercial letters of credit, as of December 31, 2007, there were no outstanding balances on the revolving line of credit.

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NOTE 9—COMMITMENTS AND CONTINGENCIES

Lease Commitments

The Company leases its facilities and certain equipment under non-cancelable operating leases that expire on various dates through 2013. Rent expense is recognized on a straight line basis over the lease term.

Future minimum lease payments as of December 31, 2007 are as follows (in thousands):

	Operating Leases	Operating Sublease Income	Net Operating Leases
Fiscal year ended September 30:			
2008 (remaining nine months)	$ 3,619	$ (185)	$ 3,434
2009	2,503	(283)	2,220
2010	2,276	(293)	1,983
2011	1,671	(86)	1,585
2012	802	—	802
Thereafter	557	—	557
Total minimum payments	$ 11,428	$ (847)	$ 10,581

Operating lease payments in the table above include approximately $3.4 millionfor two facility operating lease commitments that are included in Restructuring Expense. One of the leases is located in Boston, Massachusettsand the other is located in the United Kingdom. As of December 31, 2007, the Company has $0.8 million insublease income contractually committed for future periods relating to the Boston, Massachusetts facility classified as an operating lease. See Note 5for further discussion. The scheduled lease payments shown in the table above includes$1.2 million that was paid in the second quarter of fiscal year 2008 associated with the early termination of the United Kingdomlease. Subsequent to December 31, 2007 and as of the date of the filing of this Form 10-Q, the Company haspaid its final lease payment for the United Kingdom lease and hasbeen released from any future rent liabilities.

Asset Retirement Obligations

As required by SFAS No.143 "Accounting for Asset Retirement Obligations", or SFAS 143,and Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143", orFIN 47, the Company recorded an Asset Retirement Obligation (ARO) of approximately $0.3 million and a corresponding increase in leasehold improvementsin the fiscal year 2007. SFAS 143 and FIN 47 requires the recognition of a liability for the fair value of a legally required conditional asset retirement obligation when incurred, if the liability's fair value can be reasonability estimated. The fair value of the liability is added to the carrying amount of the associated asset and this additional carrying amount is amortized over the life of the asset.

The Company's asset retirement obligations are associated with commitments to return property subject to operating leases to original condition upon lease termination. As of December 31, 2007, the Company estimated that gross expected cash flows of approximately $0.4 million will be required to fulfill these obligations.

Asset retirement obligation payments as of December 31, 2007 are estimated as follows (in thousands):

	Payments
Fiscal year ended September 30:	
2008 (remaining nine months)	$ —
2009	—
2010	—
2011	149
2012	201
Total	$ 350

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Other Obligations

The Company entered into an agreement with Ness Technologies Inc.,Ness USA, Inc. (formerlyNess Global Services, Inc.)and Ness Technologies India, Ltd. (collectively, “Ness”), effective December 15, 2003, pursuant to which Ness provides the Company’scustomers with technical product support through a worldwide help desk facility, a sustaining engineering function that serves as the interface between technical product support and internal engineering organization, product testing services and product development services (collectively, the “Services”). The agreement had an initial term of three years and was extended for twoadditional year terms. Under the terms of the agreement, the Company pays for services rendered on a monthly fee basis, including the requirement to reimburse Nessfor approved out-of-pocket expenses. The agreement may be terminated for convenience by the Company, subject to the payment of a termination fee. In 2004, 2005, 2006 and 2007 the Company further expanded its agreement with Ness whereby Nessis providing certain additional technical and consulting services. The additional agreements can be cancelled at the option of the Company without the payment of a termination fee. The remaining minimum purchase commitment under these agreements, if Chordiant was to cancel the contracts, was approximately $0.7 million at December 31, 2007. In addition to service agreements, the Company has also guaranteed certain equipment lease obligations of Ness(see Note 8). Nessmay procure equipment to be used in performance of the Services, either through leasing arrangements or direct cash purchases, for which the Company is obligated under the agreement to reimburse them. In connection with the procurement of equipment, Ness has entered into a 36 month equipment lease agreement with IBM India and, in connection with the lease agreement the Company has an outstandingstandby letter of credit in the amount of $0.3 million in guarantee of Ness’ financial commitments under the lease. Over the term of the lease, the Company’sobligation to reimburse Ness is approximately equal to the amount of the guarantee.

Indemnification

As permitted under Delawarelaw, the Company has agreements whereby the Company has indemnifiedour officers, directors and certain employees for certain events or occurrences while the employee, officer or director is, or was serving, at the Company’srequest in such capacity. The term of the indemnification period is for the officer’s or director’s lifetime. The maximum potential amount of future payments the Companycould be required to make under these indemnification agreements is unlimited; however, the Companyhasa Director and Officer insurance policy that limits the Company’sexposure and may enable the Company to recover a portion of any future amounts paid. Future payments may be required to defend current and former directors in the derivative class action lawsuits described in Note 10.As a result of insurance policy coverage, the Companybelievesthe estimated fair value of these indemnification agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of December 31, 2007.

The Company entersinto standard indemnification agreements in our ordinary course of business. Pursuant to these agreements, the Company agrees to indemnify, defend, hold harmless, and to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally the Company’sbusiness partners or customers, in connection with any patent, copyright or other intellectual property infringement claim by any third party with respect to the Company’sproducts. The term of these indemnification agreements is generally perpetual after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. The Company has not incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. The Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of December 31, 2007.

The Company enters into arrangements with our business partners, whereby the business partners agree to provide services as subcontractors for the Company'simplementations. The Company may, at itsdiscretion and in the ordinary course of business, subcontract the performance of any of theseservices. Accordingly, the Company enters into standard indemnification agreements with itscustomers, whereby the Company indemnifies them for other acts, such as personal property damage by itssubcontractors. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has general and umbrella insurance policies that may enable the Company to recover a portion of any amounts paid. The Company has not incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of December 31, 2007.

When, as part of an acquisition, the Company acquires all of the stock or all of the assets and liabilities of a company, the Company may assume the liability for certain events or occurrences that took place prior to the date of acquisition. The maximum potential amount of future payments, if any, the Company could be required to make for such obligations is undeterminable at this time. Accordingly, the Company has no amounts recorded for these contingent liabilities as of December 31, 2007.

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The Company warrants that software products will perform in all material respects in accordance with standard published specifications and documentation in effect at the time of delivery of the licensed products to the customer for a specified period of time. Additionally, the Company warrants that maintenance and consulting services will be performed consistent with generally accepted industry standards. If necessary, the Company would provide for the estimated cost of product and service warranties based on specific warranty claims and claim history, however, the Company has not incurred significant expense under product or services warranties to date. As a result, the Company believes the estimated fair value on these warranties is minimal. Accordingly, the Company has no amounts recorded for these contingent liabilities as of December 31, 2007.

NOTE 10—LITIGATION

IPO Laddering

Beginning in July 2001, the Company and certain of its officers and directors, or individuals, were named as defendants in a series of class action stockholder complaints filed in the United States District Court for the Southern District of New York, now consolidated under the caption, "In re ChordiantSoftware, Inc. Initial Public Offering Securities Litigation, Case No. 01-CV-6222". In the amended complaint, filed in April 2002, the plaintiffs allege that the Company, the individuals, and the underwriters of the Company's initial public offering, or IPO, violated section 11 of the Securities Act of 1933 and section 10(b) of the Exchange Act of 1934 based on allegations that the Company's registration statement and prospectus failed to disclose material facts regarding the compensation to be received by, and the stock allocation practices of, the Company's IPO underwriters. The complaint also contains claims against the Individuals for control person liability under Securities Act section 15 and Exchange Act section 20. The plaintiffs seek unspecified monetary damages and other relief. Similar complaints were filed in the same court against hundreds of other public companies, or Issuers, that conducted IPO's of their common stock in the late 1990's or in the year 2000 (collectively, the "IPO Lawsuits").

In August 2001, all of the IPO Lawsuits were consolidated for pretrial purposes before United States Judge Shira Scheindlin of the Southern District of New York. In July 2002, the Company joined in a global motion to dismiss the IPO Lawsuits filed by all of the Issuers (among others). In October 2002, the Court entered an order dismissing the individuals from the IPO Lawsuits without prejudice, pursuant to an agreement tolling the statute of limitations with respect to the individuals. In February 2003, the court issued a decision denying the motion to dismiss against Chordiant and many of the other Issuers.

In June 2003, Issuers and plaintiffs reached a tentative settlement agreement that would, among other things, result in the dismissal with prejudice of all claims against the Issuers and individuals in the IPO Lawsuits, and the assignment to plaintiffs of certain potential claims that the Issuers may have against the underwriters. The tentative settlement also provides that, in the event that plaintiffs ultimately recover less than a guaranteed sum of $1 billion from the IPO underwriters, plaintiffs would be entitled to payment by each participating Issuer's insurer of a pro rata share of any shortfall in the plaintiffs' guaranteed recovery. In September 2003, in connection with the possible settlement, those individuals who had entered tolling agreements with plaintiffs (described above) agreed to extend those agreements so that they would not expire prior to any settlement being finalized. In June 2004, Chordiant and almost all of the other Issuers entered into a formal settlement agreement with the plaintiffs. On February 15, 2005, the Court issued a decision certifying a class action for settlement purposes, and granting preliminary approval of the settlement subject to modification of certain bar orders contemplated by the settlement. On August 31, 2005, the Court reaffirmed class certification and preliminary approval of the modified settlement in a comprehensive Order, and directed that Notice

of the settlement be published and mailed to class members beginning November 15, 2005. On February 24, 2006, the Court dismissed litigation filed against certain underwriters in connection with the claims to be assigned to the plaintiffs under the settlement. On April 24, 2006, the Court held a Final Fairness Hearing to determine whether to grant final approval of the settlement. On December 5, 2006, the Second Circuit Court of Appeals vacated the lower Court's earlier decision certifying as class actions the six IPO Lawsuits designated as "focus cases." Thereafter, the District Court ordered a stay of all proceedings in all of the IPO Cases pending the outcome of plaintiffs' petition to the Second Circuit for rehearing en banc. On April 6, 2007, the Second Circuit denied plaintiffs' rehearing petition, but clarified that the plaintiffs may seek to certify a more limited class in the district court. Accordingly, the settlement will not be finally approved. Plaintiffs filed amended complaints in six "focus cases" on or about August 14, 2007. The Company is not a focus case. In September 2007, the Company's named officers and directors again extended the tolling agreement with plaintiffs. On or about September 27, 2007, plaintiffs moved to certify the classes alleged in the focus cases and to appoint class representatives and class counsel in those cases. The focus case issuers filed motions to dismiss the claims against them on or about November 9, 2007 and an opposition to plaintiffs' motion for class certification on December 21, 2007. This action may divert the efforts and attention of our management and, if determined adversely to us, could have a material impact on our business, results of operations, financial condition or cash flows.

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Derivative Class Action

On August 1, 2006, a stockholder derivative complaint was filed in the United States District Court for the Northern District of California by Jesse Brown under the caption Brown v. Kelly, et al. Case No. C06-04671 JW (N.D. Cal.). On September 13, 2006, a second stockholder derivative complaint was filed in the United States District Court for the Northern District of California by Louis Suba under the caption Suba v. Kelly et al., Case No. C06-05603 JW (N.D. Cal.). Both complaints were brought purportedly on behalf of the Company against certain current and former officers and directors. On November 27, 2006, the court entered an order consolidating these actions and requiring the plaintiffs to file a consolidated complaint. The consolidated complaint was filed on January 11, 2007. The consolidated complaint alleges, among other things, that the named officers and directors: (a) breached their fiduciary duties as they colluded with each other to backdate stock options, (b) violated section 10(b), 14(a) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder through their alleged actions, and (c) were unjustly enriched by their receipt and retention of such stock options. On May 21, 2007, the Company filed a motion to dismiss the entire action on the grounds that the plaintiffs failed to take the steps necessary to bring a derivative action. Instead of opposing the motion to dismiss on November 14, 2007, the plaintiffs filed an Amended Complaint adding new allegations against five more current and former officer and directors. The substantive allegations in the Amended Complaint are similar to those in the previous complaint. On December 14, 2007, the Company again filed a motion to dismiss the entire action on the grounds that the plaintiffs failed to take the steps necessary to bring a derivative action. The individual defendants also filed a motion to dismiss. On January 22, 2008, the parties reached an agreement in principal on the settlement of this lawsuit. The parties are working to finalize and memorialize the terms of that settlement and will then seek court approval of the settlement.

Patent Claim

In September 2006, the Company received a letter from Acacia Technologies Group, a patent holding company, suggesting that the Company may be infringing on two patents, designated by United States Patent Numbers 5,537,590 and 5,701,400, which are held by one of their patent licensing and enforcement subsidiaries. The Company is currently reviewing the validity of these patents and whether the Company's products may infringe upon them. The Company has not formed a view of whether the Company may have liability for infringement of these patents. Any related claims, whether or not they have merit, could be costly and time-consuming to defend, divert management's attention or cause product delays. If any of the Company's products were found to infringe such patents, the patent holder could seek an injunction to enjoin use of the infringing product. If the Company was required to settle such a claim, it could have a material impact on our business, results of operations, financial condition or cash flows.

Yue vs Chordiant Software, Inc.

On January 2, 2008, the Company and certain of our officers and one other employee were named in a complaint filed in the United States District Court for the Northern District of California by Dongxiao Yue under the caption Dongxiao Yue v. Chordiant Software, Inc. et al. Case No. CV 08-0019 BZ (N.D. Cal.). The complaint alleges that the Company's Marketing Director software product infringed copyrights in certain software referred to as the "PowerRPC software," copyrights in which had been owned by Netbula LLC and assigned to Dr. Yue, the sole employee and owner of Netbula. The alleged infringement includes (a) distributing more copies of the PowerRPC software than had originally been authorized in a run time license Netbula granted to Chordiant Software, Intl., (b) infringement of a software developer kit ("SDK") by making copies of the SDK in excess of those that had been licensed by Netbula, (c) making unauthorized derivative works of the SDK, (d) unauthorized distribution of PowerRPC for products operating

on the Windows Vista platform, (e) unauthorized distribution of PowerRPC for server based products.Plaintiff also claims that the license Netbula granted to Chordiant Software, Int'l Ltd. should not be construed to authorize uses by its parent company, Chordiant Software, Inc. The plaintiff seeks monetary damages, disgorgement of profits, and injunctive relief according to proof. The Company and its officers and employee will serve their response to the complaint on or after February 13, 2008.

The Company, from time to time, is also subject to various other claims and legal actions arising in the ordinary course of business. The ultimate disposition of these various other claims and legal actions is not expected to have a material effect on our business, financial condition, results of operations or cash flows. However, litigation is subject to inherent uncertainties.

NOTE 11—INCOME TAXES

Effective October 1, 2007, the Company adopted FIN No. 48 "Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109". FIN 48 prescribes a recognition threshold and measurement guidance for the financial statement reporting of uncertain tax positions taken or expected to be taken in a company's income tax return. FIN 48 also provides guidance related to recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition matters related to uncertain tax positions. FIN 48 utilizes a two-step approach for evaluating uncertain tax positions accounted for in accordance with SFAS 109. Step one, recognition, requires a company to determine if the weight of available

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evidence indicates that a tax position is more likely than not to be sustained upon audit, including the resolution of related appeals or litigation processes, if any. Step two, measurement, is based on the largest amount of benefit which is more likely than not to be realized on ultimate settlement. The cumulative effect of adopting FIN 48, if any, is recorded as an adjustment to the opening balance of retained earnings as of the adoption date.

The net income tax assets recognized under FIN 48 did not materially differ from the net assets recognized before adoption, and, therefore, the Company did not record an adjustment to retained earnings related to the adoption of FIN 48. At the adoption date of October 1, 2007, the Company had $0.8 million of unrecognized tax benefits related to tax positions taken in prior periods, $0.2 million of which would affect the Company's effective tax rate if recognized.

The Company recognizes accrued interest and penalties related to unrecognized tax benefits in the Provision for Income Taxes. The Company had less than $0.1 million accrued for interest and penalties as of December 31, 2007.

The Company files income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. With few exceptions, all U.S. federal, state and United Kingdom tax years between 1995 and 2007 remain open to examination due to net operating loss carryforwards and credit carryforwards. Tax years 2003 and later remain open to examination in Canada and years 2004 and later remain open to examination in Germany.

Tax audits of the 2005 tax year are currently in process in the Netherlands and Canada. The Company does not expect resolution of these audits to have a material impact on our financial statements and the Company does not expect a significant increase or decrease in unrecognized tax benefits over the next 12 months.

The Company provides a valuation allowance for deferred tax assets when it is more likely than not that the net deferred tax assets will not be realized. Based on a number of factors, including the lack of a history of profitsprior to 2007 and the fact that the market in which we compete is intensely competitive and characterized by rapidly changing technology, the Company believes that there is sufficient uncertainty regarding the realization of deferred tax assets such that a full valuation allowance has been provided. At December 31, 2007, the Companyhad approximately $127.6 million and $18.9 million of net operating loss carryforwards for federal and state purposes, respectively, and net operating loss carryforwards of approximately $34.6 million in the United Kingdom. As a result of an IRC Section 382 study completed during fiscal 2008, it was determined that $19.6 million of net operating loss carryforwards resulting from the acquisition of Prime Response will expire unutilized. The $127.6 million in total federal net operating loss carryforwards is presented net of these Section 382 limitations. Upon being realized, the remaining $13.8 million of the Prime Response federal net operating loss carryforwards will reduce goodwill and intangibles recorded at the date of acquisition before reducing the tax provision. Approximately $3.5 million of additional net operating loss carryforwards are related to stock option deductions which, if utilized, will be accounted for as an addition to equity rather than as a reduction of the provision for income taxes. The net operating loss carryforwards are available to offset future federal and state taxable income and expire in years from 2008 through 2026. At December 31, 2007, there are approximately $3.5 million of federal research and development credits and alternative minimum tax credits that expire in years 2011 through 2027. At December 31, 2007, there were also California state credits of approximately $3.5 million that do not expire.

NOTE 12—EMPLOYEE BENEFIT PLANS

2005 Equity Incentive Plan

As of December 31, 2007, there were approximately 1.9 million shares available for future grant and approximately 3.4million options that areoutstanding under the 2005 Equity Incentive Plan or 2005 Plan. In December 2007, the Board amended the 2005 plan to increase the number of shares reserved for future issuance by 0.7 million shares. This amendment was approved by the stockholders at the2008 Annual Meeting of Stockholders' held on February 1, 2008.

In October 2007,the Company granted 0.2 million performance-based restricted stock units or RSUs to selected executivesof the Companypursuant to the 2005 Plan. The performance-based restricted stock units cliff vest at the end of a two year requisite service period, constituting the Company's fiscal years 2008 and 2009,upon achievement of specified performance criteria established by the Compensation Committee of our Board of Directors. The award agreements for RSUs generally provide that vesting will be accelerated in certain events related to changes in control of the Company. Total compensation cost for these awards isbased on the fair market value of the shares at the date of grant. The portion of the total compensation cost related to the performance-based awards is subject to adjustment each quarter based on management's assessment of the likelihood of achieving the two year performance criteria.

2000 Nonstatutory Equity Incentive Plan

As of December 31, 2007, there were approximately 0.4 million options that areoutstanding under the 2000 Nonstatutory Equity Incentive Plan.

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1999 Non-Employee Directors' Option Plan

As of December 31, 2007, there were approximately 0.3million shares of common stock are available for future grant and 0.2millionoptions that are outstanding under the 1999 Non-Employee Directors' Option Planor Directors' Plan. In December 2007, the Board amended the Directors' Plan to incorporate the following changes:

1. expand the type of awards that may be granted under the Directors' Plan to allow restricted stock awards and restricted stock unit awards; and
2. for fiscal year 2008 and thereafter, directors will be awarded restricted stock awards instead of stock options for their annual and initial automatic Board service award.

This amendment was approved by the stockholders at the2008 Annual Meeting of Stockholders' held on February 1, 2008.

Stock Option Activity

The following table summarizes stock option, restricted stock unitsand restricted stockawardsactivity under our stock option plans (in thousands, except per share data):

	Shares Available for Grant	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value Closing Price at 12/31/2007 of $8.55
Balance at September 30, 2007	3,058	3,178	$ 7.96		
Authorized	—	—	—		
Options and awards granted	(919)	919	9.70		
Options exercised	—	(88)	6.46		
Cancellation of unvested restricted stock	—	—	—		
Options and awards cancelled/forfeited	39	(39)	11.30		
Authorized reduction in shares from existing plans	(4)	—	—		
Balance at December 31, 2007	2,174	3,970	$ 8.36	8.22	$ 3,847
Vested and expected to vest at December 31, 2007		3,029	$ 8.20	7.97	$ 3,449
Exercisable at December 31, 2007		1,592	$ 7.41	6.87	$ 2,946

The following table summarizes information about stock options outstanding and exercisable at December 31, 2007 (in thousands, except exercise prices and contractual life data):

Options Outstanding Options Exercisable

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Aggregate Intrinsic Value Closing Price at 12/31/2007 of $8.55	Number Exercisable	Weighted Average Exercise Price	Aggregate Intrinsic Value Closing Price at 12/31/2007 of $8.55
$0.35 – 6.45	570	5.82	$ 4.02	$ 2,584	484	$ 3.82	$ 2,290
6.48 – 7.80	543	7.70	7.18	745	321	7.08	472
7.88 – 8.15	439	7.93	7.98	250	209	7.99	118
8.25 – 8.25	817	9.10	8.25	245	193	8.25	58
8.28 – 9.23	179	7.73	8.53	23	80	8.61	8
9.25 – 9.25	814	9.88	9.25	—	30	9.25	—
9.26 – 45.00	608	7.89	12.67	—	275	12.53	—
$0.35 – 45.00	3,970	8.22	$ 8.36	$ 3,847	1,592	$ 7.41	$ 2,946

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The aggregate intrinsic value in the preceding table represents the total intrinsic value, based on the Company's closing stock price of $8.55 as of December 31, 2007, which would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options vested and exercisable as of December 31, 2007 was approximately 1.3 million. As of December 31, 2007, approximately 1.6 million outstanding options were vested and exercisable, and the weighted average exercise price was $7.41. The total intrinsic value of options exercised during the three months ended December 31, 2007and 2006was $0.7 million and $0.2 million respectively.The fair value of options vested for the three months ended December 31, 2007 and 2006 was $0.6 million for each period. As of December 31, 2007, total unrecognized compensation costs related to non-vested stock options was $7.0 million, which is expected to be recognized as expense over a weighted-average period of approximately 2.9 years. As of December 31, 2006, total unrecognized compensation costs related to non-vested stock options was $3.8 million, which wasexpected to be recognized as expense over a weighted-average period of approximately 1.3 years.

The Company had nounvested restricted stock awards as of December 31, 2007. The Company had 0.4 million unvested restricted stock awards as of December 31, 2006. The total fair value of the unvested restricted stock awards at grant date was $0.8 million. Aggregate intrinsic value of the unvested restricted stock awards at December 31, 2006 was $1.3million. During the three months ended December 31, 2006, approximately 0.3 million shares vested related to restricted stock awards. The weighted average fair value at grant date of the unvested restricted stock awards was $5.25 as of December 31, 2006. As of December 31, 2006, total unrecognized compensation costs related to unvested restricted stock awards was $0.1 million which wasto be recognized as expense over a weighted average period of approximately 1.0 year.

As of December 31, 2007, the total fair value and number of vested RSUs was zero. Based upon management's assessment of the likelihood of achieving the two year performance criteria, the Company has 0.1 million of unvested RSUs with an average fair value of $15.38 per unit. During the three months ended December 31, 2007, $0.3 million of stock compensation expense related to the performance-based RSUs has been recognized.The total unrecognized compensation costs related to unvested RSUs was $1.9 million which is expected to be recognized as expense over a weighted average period of approximately 21 months. If the maximum target of RSUs outstanding were assumed to be earned, total unrecognized compensation costs would be approximately $3.0 million which would be expected to be recognized as expense over a weighted average period of approximately 21 months.

The Company settles stock option exercises, restricted stock units and restricted stock awards with newly issued common shares.

Valuation and Expense Information under SFAS 123(R)

On October 1, 2005, the Company adopted SFAS 123(R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to the Company's employees and directors including employee stock options, restricted stock awards, restricted stock unitsand employee stock purchases related to the Employee Stock Purchase Planbased on estimated fair values. The following table summarizes stock-based compensation expense related to employee stock options,restricted stock awardsand RSUsfor the three months ended December 31, 2007and 2006, respectively, which was allocated as follows (in thousands):

	Three Months Ended December 31,	
	2007	2006

Stock-based compensation expense:				
Cost of revenues	$	153	$	107
Sales and marketing		241		329
Research and development		199		93
General and administrative		582		447
Total stock-based compensation expense	$	1,175	$	976

The weighted-average estimated fair value of stock options granted during the three months ended December 31, 2007 and 2006 was $4.43 and $4.03 per share, respectively, using the Black-Scholes model with the following weighted-average assumptions:

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	Three Months Ended December31,	
	2007	2006
Expected lives in years	3.5	3.6
Risk free interest rates	3.4%	4.6%
Volatility	59%	71%
Dividend yield	0%	0%

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model with the weighted-average assumptions for volatility, expected term, and risk free interest rate. With the adoption of SFAS 123(R) on October 1, 2005, the Company used the trinomial lattice valuation technique to determine the assumptions used in the Black-Scholes model. The trinomial lattice valuation technique was used to provide a better estimate of fair values and meet the fair value objectives of SFAS 123(R). The expected term of options granted is derived from historical data on employee exercises and post-vesting employment termination behavior. The risk-free rate is based on the U.S. Treasury rates in effect during the corresponding period of grant. The expected volatility rate is based on the historical volatility of our stock price.

As stock-based compensation expense recognized in the Condensed Consolidated Statement of Operations for the three months ended December 31, 2007 and 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Our estimated forfeiture rate for the three months ended December 31, 2007 and 2006 was based on our historical forfeiture experience.

Accuracy of Fair Value Estimates

The Company uses third party analyses to assist in developing the assumptions based on a trinomial lattice valuation technique used in the Black-Scholes model. The Company is responsible for determining the assumptions used in estimating the fair value of share-based payment awards.

Thisdetermination of fair value of share-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 highly complex and subjective variables. These variables include, but are not limited to the Company's expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. Because the Company's employee stock options have certain characteristics that are significantly different from traded options, and because changes in the subjective assumptions can materially affect the estimated value, in management's opinion, the existing valuation models may not provide an accurate measure of the fair value of the Company's employee stock options and restricted stock awards. Although the fair value of employee stock options and restricted stock awards is determined in accordance with SFAS 123(R) and SAB 107 using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

NOTE 13—SEGMENT INFORMATION

Our chief operating decision maker reviews financial information presented on a consolidated basis, accompanied by desegregated information about revenues by geographic regions for purposes of making operating decisions and assessing financial performance. Accordingly, the Company has concluded that the Company has one reportable segment.

The following table summarizes license revenue by product emphasis (in thousands):

	Three Months Ended December 31, 2007	2006
License revenue:		
Enterprisesolutions	$ 6,214	$ 3,545
Marketing solutions	714	989
Decision management solutions	1,879	2,628
Total	$ 8,807	$ 7,162

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The following table summarizes service revenue consisting of consulting implementationand integration, consulting customization, training,post-contract customer supportservices, or PCS and certainreimbursable out-of-pocket expenses by product emphasis (in thousands):

	Three Months Ended December 31,	
	2007	2006
Servicerevenue:		
Enterprisesolutions	$ 15,209	$ 12,199
Marketing solutions	3,118	2,605
Decision management solutions	2,000	973
Total	$ 20,327	$ 15,777

Foreign revenues are based on the country in which the customer order is generated. The following is a summary of total revenues by geographic area (in thousands):

	Three Months Ended December 31,	
	2007	2006
North America	$ 15,591	$ 13,221
Europe	13,543	9,718
Total	$ 29,134	$ 22,939

Included in foreign revenue results for Europe are revenue from the United Kingdomof $6.1 millionand $6.3 millionfor the three months ended December 31, 2007and 2006, respectively.

Property and equipment, netinformation is based on the physical location of the assets. The following is a summary of property and equipment by geographic area (in thousands):

	December 31 2007	September 30, 2007
North America	$ 2,719	$ 2,346
Europe	1,238	1,292
Total	$ 3,957	$ 3,638

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

This discussion and analysis should be read in conjunction with ourCondensed Consolidated Financial Statements and accompanying Notes included in this report and the 2007 Audited Financial Statements and Notes thereto included in our Annual Report on Form 10-K for the year ended September 30, 2007 filed with the SEC. Operating results are not necessarily indicative of results that may occur in future periods.

The following discussion and analysis contains forward-looking statements. These statements are based on our current expectations, assumptions, estimates and projections about our business and our industry, and involve known and unknown risks, uncertainties and other factors that may cause our or our industry's results, levels of activity, performance or achievement to be materially different from any future results, levels of activity, performance or achievements expressed or implied in or contemplated by the forward-looking statements. Words such as "believe," "anticipate," "expect," "intend," "plan," "will," "may," "should," "estimate," "predict," "guidance," "potential," "continue" or such terms or other similar expressions, identify forward-looking statements. Our actual results and the timing of events may differ significantly from those discussed in the forward-looking statements as a result of various factors, including but not limited to, those discussed under the subheading "Risk Factors" and those discussed elsewhere in this report, in our other SEC filings and under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our 2007 Form 10-K. Chordiant undertakes no obligation to update any forward-looking statement to reflect events after the date of this report.

Overview

As an enterprise software vendor, we generate substantially all of our revenues from the banking, insurance, healthcare, telecommunications, and retail industries. Our customers typically fund purchases of our software and services out of their lines of business and information technology budgets. As a result, our revenues are heavily influenced by our customers' long-term business outlook and willingness to invest in new enterprise information systems and business applications.

For the three months ended December 31, 2007, total revenues increased 27% and backlog increased 38% as compared to the same period of the prior year. For the three months ended December 31, 2007, backlog increased $20.6million or 27% compared to the previous three months ended September 30, 2007. This increase in backlog is primarily related to a large telecommunications customer commitment entered into during the quarter totaling $26.1 million for license and support services. Under the terms of the commitment, the customer is required to purchase $26.1 million of license and support services over a period of approximately 28 months ending April 1, 2010. We recognized $1.5 million of license and service revenue associated with this transaction during the quarter and expect to recognize the remainder of the backlog revenue over the commitment period according to scheduled minimum purchase amounts and dates. To the extent the customer places orders in advance of the commitment dates, the timing of the license and support revenue could be accelerated versus the scheduled purchase dates and amounts.

Software Industry Consolidation and Possible Increased Competition

The enterprise software industry continues to undergo consolidation in sectors of the software industry in which we operate. Within the last 12 months, IBM acquired Cognos, DataMirror and Watchfire Corporation, Oracle completed its acquisition of Hyperion and Moniforce and has entered into an agreement to purchase BEA Systems, Sun Microsystems has entered in an agreement to purchase MySQL and SAP acquired BusinessObjects, YASU Technologies and Pilot Software. While we do not believe that Cognos, DataMirror, Watchfire Corporation, Hyperion, Moniforce, BEA Systems, MySQL, BusinessObjects, YASU Technologies, or Pilot Software have been significant competitors of Chordiant in the past, the acquisition of these companies by IBM, ,Oracle, Sun Microsystems and SAP may indicate that we will face increased competition from larger and more established entities

in the future.

Financial Trends

Backlog. Our revenues havebeen derived from large customer transactions. For some of these transactions, the associated professional services provided to the customer can span over a period greater than one year. If the services delivery period is over a prolonged period of time, it will cause the associated backlog to be recognized as revenue over a similar period of time. As of December 31, 2007 and 2006, we had approximately $96.0 million and $69.8 million in backlog, respectively, which we define as contractual commitments by our customers through purchase orders or contracts. Backlog at December 31, 2007 includes approximately $25.2 million relating to a large telecommunications customer commitment. The increase in backlog is partially offset by a decline in deferred revenue recorded on our Condensed Consolidated Balance Sheets. For the period ended December 31, 2006 to December 31, 2007 aggregate deferred revenue balances decreased $4.4 million due to a decrease of $7.1 million in short-term deferred revenue and an increase of $2.7 million in long-term deferred revenue. Theincrease in long-term deferred revenue was primarily driven by entering into multi-year support and maintenance contracts with our customers. Backlog is comprised of:

- software license orders which the delivered products have not been accepted by customers or have not otherwise met all of the required criteria for revenue recognition. This component includes billed amounts classified as deferred revenue;

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- deferred revenue from customer support contracts;
- consulting service orders representing the unbilled remaining balances of consulting contracts not yet completed or delivered, plus deferred consulting revenue where we have not otherwise met all of the required criteria for revenue recognition.

Backlog is not necessarily indicative of revenues to be recognized in a specified future period. There are many factors that would impact Chordiant's conversion of backlog as recognizable revenue, such as Chordiant's progress in completing projects for its customers, Chordiant's customers' meeting anticipated schedules for customer-dependent deliverables and customers increasing the scope or duration of a contract causing license revenue to be deferred for a longer period of time.

Chordiant provides no assurances that any portion of its backlog will be recognized as revenue during any fiscal year or at all, or that its backlog will be recognized as revenues in any given period. In addition, it is possible that customers from whom we expect to derive revenue from backlog will default and as a result we may not be able to recognize expected revenue from backlog.

Implementation by Third Parties.Over time, as our products mature and system integrators become more familiar with our products, our involvement with implementations has diminished on some projects. If this trend continues to evolve, certain agreements with customers may transition from a contract accounting model (SOP 81-1) to a more traditional revenue model whereby revenues are recorded upon delivery(SOP 97-2).

Service Revenues. Service revenues as a percentage of total revenues were 70% and 69% for the three months ended December 31, 2007 and 2006, respectively. While the composition of revenue will continue to fluctuate on a quarterly basis, we expect that service revenues will represent between 50% and 60% of our total annual revenues in the foreseeable future.

Revenues fromInternational Customers versus North America. For all periods presented, revenues were principally derived from customer accounts in North America and Europe. For the three months ended December 31, 2007 and 2006, international revenues were $13.5 million and $9.7 million, or approximately 46% and 42%, respectively,of our total revenues. We believe international revenues will continue to represent a significant portion of our total revenues in future periods. International revenues were favorably impacted for the three months ended December 31, 2007, as compared to the three months ended December 31, 2006, as both the British Pound and the Euro increased in average value by approximately 7% and 12%, respectively, as compared to the U.S. Dollar.

For the three months ended December 31, 2007 and 2006, North Americarevenues were $15.6 million and $13.2 million, or approximately 54% and 58%, respectivelyof our total revenues. As the U.S.economy has remained strong, we have seen an increase in North Americarevenues. Large customers have become more willing to invest in new enterprise infrastructure projects. We believe North Americarevenues will continue to represent 50% to 60% of our total revenues in the future.

Gross Margins. Management focuses on license and service gross margin in evaluating our financial condition and operating performance. Gross margins on license revenues were 96% and 94% for the three months ended December 31, 2007 and 2006, respectively. The 2% increaseis primarily a function of the fixed periodic amortization costs associated with capitalized software costs being divided by a largerlicense amount quarter-over-quarter. We expect license gross margin on current products to range from 95% to 97% in the foreseeable future. The margin will fluctuate with the mix of products sold. Historically, the enterprise solution products have higher associated third party royalty expense than the marketing solution products and decision management products.

Gross margins on service revenues were 58% and 53% for the three months ended December 31, 2007 and 2006, respectively. The increase in gross margins for the three months period ending December 31, 2007 is primarily due to improved consulting services utilization rates and increased support and maintenance revenue. We expect that gross margins on service revenues to range between 55% and 60% in the foreseeable future.

Costs Related to Stock Option Investigation. For the three months ending December 31, 2006, significant outside professional servicescostsare included in general and administrative costs associated with the Company's stock option investigation which began in July 2006 and was completed during the quarter ended March 31, 2007. This issue is more fully described in the in Note 3, "Restatement of Previously Issued Consolidated Financial Statements" in Notes to Consolidated Financial Statements of the Annual Report on Form 10-K for the fiscal year ended September 30, 2006. For the quarter ended December 31, 2006, these costs were $1.0 million. We have not incurred any additional costs since the quarter ended March 31, 2007 and do not expect to incur such costs in future periods.

Cost to Amend Eligible Options. In July 2006, our Board of Directors (the "Board") initiated a review of our historical stock option grant practices and appointed the Audit Committee to oversee the investigation. The Audit Committee determined that the correct measurement dates for a number of stock option grants made by us during the period 2000 to 2006, or Review Period, differ from the measurement dates previously used to account for such option grants. The Audit Committee identified

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errors related to the determination of the measurement dates for grants of options where the price of our common stock on the selected grant date was lower than the price on the actual grant date which would permit recipients to exercise these options at a lower exercise price. As such, these affected stock options are deemed, for accounting purposes, to have been granted at a discount. Based on the determination made for accounting purposes, the discounted options (for accounting purposes) may now be deemed to have been granted at a discount for tax purposes, which may expose the holders of these impacted stock option grants to potentially adverse tax treatment under Section 409A of the Internal Revenue Code and state law equivalents. As more fully described on Form SC TO-I filed with the SEC on March 29, 2007, Chordiant offered certain optionees the opportunity to increase the exercise price of the discounted options to limit the potential adverse personal tax consequences that may apply to those stock options under Section 409A of the Internal Revenue Code and state law equivalents. On April 26, 2007, eligible optionees finalized their elections under the offer and were awarded a future cash payment equal to the price differential of the Amended Options. These payments will be treated as bonus payments. These cash payments were approximately $0.3 million and were paid out in January 2008. The cost of these bonus payments were fully accrued as of December 31, 2007.

Reduction in Workforce. In October 2006, the Company initiated a restructuring plan intended to align its resources and cost structure with expected future revenues. The restructuring plan included a balancing of services resources worldwide, an elimination of duplicative functions internationally, and a shift in the U.S.field organization toward a focus on domain-based sales and pre-sales teams.

The restructuring plan included an immediate reduction in positions of slightly more than ten percent of the Company's workforce, consolidation of our European facilities, and the closure of our Franceoffice. A majority of the positions eliminated were in Europe. The plan was committed to on October 24, 2006, and we began notifying employees on October 25, 2006.

We initially recorded a pre-tax cash restructuring expense of $6.5 million as calculated using the net present value of the related costs as required by SFAS 146. The expense was composed of costs for severance and exiting excess facilities. In November 2007, we negotiated a break clause in the lease allowing for an early termination of the United Kingdom facility which will release us of any future rent liabilities subsequent to January 2008. Subsequent to December 31, 2007 and as of the date of the filing of this Form 10-Q, we have paid the final lease payment for the United Kingdom lease and have been released from any future rent liabilities.

In July 2005, we undertook an approximate 10% reduction in our workforce. In connection with this action, we incurred a one-time cash expense of approximately $1.1 million in the fourth quarter ended September 30, 2005 for severance benefits. As of December 31, 2007, $0.1million of the cash charges remains outstanding.

During fiscal year 2002, we restructured several areas of the Company to reduce expenses and improve revenues. As part of this restructuring, we closed an office facility in Boston, Massachusettsand recorded an expense associated with the long-term lease which expires in January 2011. During the three months ended March 31, 2007, we completed a new sublease with a sub-lessee for the remaining term of our lease at a rate lower than that which was forecasted when the original restructuring expense was recorded in 2002. This change in estimate resulted in a $0.4 million restructuring expense for the year ended September 30, 2007.

Past Results may not be Indicative of Future Performance. We believe that period-to-period comparisons of our operating results should not be relied upon as indicative of future performance. Our prospects must be considered given the risks, expenses and difficulties frequently encountered by companies in early stages of development, particularly companies in new and rapidly evolving businesses. There can be no assurance we will be successful in addressing these risks and difficulties. Moreover, we may not achieve or maintain profitability in the future.

Critical Accounting Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our Condensed Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities.

On an on-going basis, we evaluate the estimates, including those related to our allowance for doubtful accounts, valuation of stock-based compensation, valuation of goodwill and intangible assets, valuation of deferred tax assets, restructuring expenses, contingencies, vendor specific objective evidence, or VSOE, of fair value in multiple element arrangements and the estimates associated with the percentage-of-completion method of accounting for certain of our revenue contracts. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the recognition of revenue and expenses that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting judgments and estimates are used in the preparation of our Condensed Consolidated Financial Statements:

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- Revenue recognition, including estimating the total estimated time required to complete sales arrangements involving significant implementation or customization essential to the functionality of our products;
- Estimating valuation allowances and accrued liabilities, specifically the allowance for doubtful accounts, and assessment of the probability of the outcome of our current litigation;
- Stock-based compensation expense;
- Accounting for income taxes;
- Valuation of long-lived and intangible assets and goodwill;
- Restructuring expenses; and
- Determining functional currencies for the purposes of consolidating our international operations.

Revenue Recognition. We derive revenues from licenses of our software and related services, which include assistance in implementation, customization and integration, post-contract customer support, training and consulting. The amount and timing of our revenue is difficult to predict and any shortfall in revenue or delay in recognizing revenue could cause our operating results to vary significantly from quarter to quarter and could result in operating losses. The accounting rules related to revenue recognition are complex and are affected by interpretation of the rules and an understanding of industry practices, both of which are subject to change. Consequently, the revenue recognition accounting rules require management to make significant estimates based on judgment.

Software license revenue is recognized in accordance with AICPA's Statement of Position No. 97-2 "Software Revenue Recognition," as amended by Statement of Position No. 98-9 "Software Revenue Recognition with Respect to Certain Arrangements", or collectively SOP 97-2.

For arrangements with multiple elements, we recognize revenue for services and post-contract customer support based upon the fair value VSOE of the respective elements. The fair value VSOE of the services element is based upon the standard hourly rates we charge for the services when such services are sold separately. The fair value VSOE for annual post-contract customer support is generally established with the contractual future renewal rates included in the contracts, when the renewal rate is substantive and consistent with the fees when support services are sold separately. When contracts contain multiple elements and fair value VSOE exists for all undelivered elements, we account for the delivered elements, principally the license portion, based upon the "residual method" as prescribed by SOP 97-2. In multiple element transactions where VSOE is not established for an undelivered element, we recognize revenue upon the establishment of VSOE for that element or when the element is delivered.

At the time we enter into a transaction, we assess whether any services included within the arrangement related to significant implementation or customization essential to the functionality of our products. For contracts for products that do not involve significant implementation or customization essential to the product functionality, we recognize license revenues when there is persuasive evidence of an arrangement, the fee is fixed or determinable, collection of the fee is probable and delivery has occurred as prescribed by SOP 97-2. For contracts that involve significant implementation or customization essential to the functionality of our products, we recognize the license and professional consulting services revenue using either the percentage-of-completion method or the completed contract method as prescribed by Statement of Position No. 81-1, "Accounting for Performance of Construction-Type and Certain Product-Type Contracts", or SOP 81-1.

The percentage-of-completion method is applied when we have the ability to make reasonably dependable estimates of the total effort required for completion using labor hours incurred as the measure of progress towards completion. The progress toward completion is measured based on the “go-live” date. We define the “go-live” date as the date the essential product functionality has been delivered or the application enters into a production environment or the point at which no significant additional Chordiant supplied professional service resources are required. Estimates are subject to revisions as the contract progresses to completion. We account for the changes as changes in accounting estimates when the information becomes known. Information impacting estimates obtained after the balance sheet date but before the issuance of the financial statements is used to update the estimates. Provisions for estimated contract losses, if any, are recognized in the period in which the loss becomes probable and can be reasonably estimated. When we sell additional licenses related to the original licensing agreement, revenue is recognized upon delivery if the project has reached the go-live date, or if the project has not reached the go-live date, revenue is recognized under the percentage-of-completion method. We classify revenues from these arrangements as license and service revenue based upon the estimated fair value of each element using the residual method.

The completed contract method is applied when we are unable to obtain reasonably dependable estimates of the total effort required for completion. Under the completed contract method, all revenue and related costs of revenue are deferred and recognized upon completion.

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For product co-development arrangements relating to software products in development prior to the consummation of the individual arrangements where we retain the intellectual property being developed and intend to sell the resulting products to other customers, license revenue is deferred until the delivery of the final product, provided all other requirements of SOP 97-2 are met. Expenses associated with these co-development arrangements are accounted for under SFAS 86 and are normally expensed as incurred as they are considered to be research and development costs that do not qualify for capitalization or deferral.

Revenue from subscription or term license agreements, which include software and rights to unspecified future products or maintenance, is recognized ratably over the term of the subscription period. Revenue from subscription or term license agreements, which include software, but exclude rights to unspecified future products and maintenance, is recognized upon delivery of the software if all conditions of recognizing revenue have been met including that the related agreement is non-cancelable, non-refundable and provided on an unsupported basis.

For transactions involving extended payment terms, we deem these fees not to be fixed or determinable for revenue recognition purposes and revenue is recognized.

For arrangements with multiple elements accounted for under SOP 97-2 where we determine we can account for the elements separately and the fees are not fixed or determinable due to extended payment terms, revenue is recognized in the following manner. If the undelivered element is PCS, or other services, an amount equal to the estimated value of the services to be rendered prior to the next payment becoming due is allocated to the undelivered services. The residual of the payment is allocated to the delivered elements of the arrangement.

For arrangements with multiple elements accounted for under SOP 81-1 where we determine we can account for the elements separately and the fees are not fixed or determinable due to extended payment terms, revenue is recognized in the following manner. Amounts are first allocated to the undelivered elements included in the arrangement, as payments become due or are received, the residual is allocated to the delivered elements.

We recognize revenue for post-contract customer support ratably over the support period which ranges from one to five years.

Our training and consulting services revenues are recognized as such services are performed on an hourly or daily basis for time and material contracts. For consulting services arrangements with a fixed fee, we recognize revenue on a percentage-of-completion method.

For all sales we use either a signed license agreement or a binding purchase order where we have a master license agreement as evidence of an arrangement. Sales through our third party systems integrators are evidenced by a master agreement governing the relationship together with binding purchase orders or order forms on a transaction-by-transaction basis. Revenues from reseller arrangements are recognized on the “sell-through” method, when the reseller reports to us the sale of our software products to end-users. Our agreements with customers and resellers do not contain product return rights.

We assess collectibility based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. We generally do not request collateral from our customers. If we determine that the collection of a fee is not probable, we recognize revenue at the time collection becomes probable, which is generally upon the receipt of cash.

Allowance for Doubtful Accounts. We must make estimates of the uncollectability of our accounts receivables. We specifically analyze accounts receivable and analyze historical bad debts, customer concentrations, customer

credit-worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. Generally, we require no collateral from our customers. Our gross accounts receivable balance was $21.1 million with an allowance for doubtful accounts of $0.1 million as of December 31, 2007. Our gross accounts receivable balance was $28.5 million (including long-term accounts receivable of $1.0 million)with an allowance for doubtful accounts of $0.2 million as of September 30, 2007. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances would be required. To date, bad debts have not been material and have been within management's expectations.

Stock-based Compensation Expense. Upon adoption of SFAS 123(R) on October 1, 2005, we began estimating the value of employee stock awardson the date of grant using the Black-Scholes model. Prior to the adoption of SFAS 123(R), the value of each employee stock awardwas estimated on the date of grant using the Black-Scholes model for the purpose of the pro forma financial disclosure in accordance with SFAS 123. The determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors.

With the adoption of SFAS 123(R) on October 1, 2005, we used the trinomial lattice valuation technique to determine the assumptions used in the Black-Scholes model. The trinomial lattice valuation technique was used to provide better estimates of

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fair values and meet the fair value objectives of SFAS 123(R). The expected term of options granted is derived from historical data on employee exercises and post-vesting employment termination behavior. The expected volatility is based on the historical volatility of our stock.

As stock-based compensation expense recognized in the Condensed Consolidated Statement of Operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience.

If factors change and we employ different assumptions in the application of SFAS 123(R) in future periods, the compensation expense that we record under SFAS 123(R) may differ significantly from what we have recorded in the current period. The estimated value of a stock option is most sensitive to the volatility assumption. Based on the December 31, 2007 variables, it is estimated that a change of 10% in either the volatility, expected life or interest rate assumption would result in a corresponding 8%, 5% or 1% change, respectively,in the estimated value of the option being valued using the Black-Scholes model.

As stock-based compensation expense attributable to performance restricted stock units, or RSUs, is based on management’s assessment of the likelihood of achieving certain criteria, the amount of expense that is recorded in a period is dependent on the accuracy of management’s estimates. It is estimated that a 5% change in management’s achievement estimates would result in a corresponding 22% change in the stock compensation expense recorded for the period. The RSUs granted vest at the end of fiscal year 2009 if certain specified performance criteria are achieved. It is expected that estimates will become more accurate leading up to September 30, 2009.

Accounting for Income Taxes.As part of the process of preparing our Condensed Consolidated Financial Statements we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as deferred revenue, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our Condensed Consolidated Balance Sheets. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we must include an expense within the tax provision in the statement of operations.

We have recorded a valuation allowance equal to 100% of the deferred tax assets as of December 31, 2007, due to uncertainties related to our ability to utilize our net deferred tax assets, primarily consisting of certain net operating loss carryforwards,research and development creditsand temporary differences relating to deferred revenue. Deferred tax assets have been fully reserved for in all periods presented.

Effective October 1, 2007, the Company adopted Financial Accounting Standards Interpretation, No. 48 “Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109” or FIN 48. FIN 48 prescribes a recognition threshold and measurement guidance for the financial statement reporting of uncertain tax positions taken or expected to be taken in a company’s income tax return. The application of FIN 48 is explained in Note 11 to the Condensed Consolidated Financial Statements.

Valuation of Long-lived and Intangible Assets and Goodwill.We assess the impairment of identifiable intangibles and long-lived assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Furthermore, we assess the impairment of goodwill annually. Factors we consider important which could trigger an impairment review include the following:

- Significant underperformance relative to expected historical or projected future operating results;
- Significant changes in the manner of our use of the acquired assets or the strategy for our overall business;
- Significant negative industry or economic trends;
- Significant decline in our stock price for a sustained period;
- Market capitalization declines relative to net book value; and
- A current expectation that, more likely than not, a long-lived asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

When one or more of the above indicators of impairment occurs we estimate the value of long-lived assets and intangible assets to determine whether there is impairment. We measure any impairment based on the projected discounted cash flow

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method, which requires us to make several estimates including the estimated cash flows associated with the asset, the period over which these cash flows will be generated and a discount rate commensurate with the risk inherent in our current business model. These estimates are subjective and if we made different estimates, it could materially impact the estimated fair value of these assets and the conclusions we reached regarding impairment. To date, we have not identified any triggering events noted above.

We are required to perform an impairment review of our goodwill balance on at least an annual basis. This impairment review involves a two-step process as follows:

Step 1—We compare the fair value of our reporting units to the carrying value, including goodwill, of each of those units. For each reporting unit where the carrying value, including goodwill, exceeds the unit's fair value, we proceed on to Step 2. If a unit's fair value exceeds the carrying value, no further work is performed and no impairment charge is necessary.

Step 2—We perform an allocation of the fair value of the reporting unit to our identifiable tangible and non-goodwill intangible assets and liabilities. This derives an implied fair value for the reporting unit's goodwill. We then compare the implied fair value of the reporting unit's goodwill with the carrying amount of the reporting unit's goodwill. If the carrying amount of the reporting unit's goodwill is greater than the implied fair value of its goodwill, an impairment charge would be recognized for the excess.

We determined that we have one reporting unit. We completed a goodwill impairment review for the period ending September 30, 2007 and performed Step 1 of the goodwill impairment analysis required by SFAS 142, "Goodwill and Other Intangible Assets," and concluded that goodwill was not impaired as of September 30, 2007 using the methodology described above. Accordingly, Step 2 was not performed. We will continue to test for impairment on an annual basis and on an interim basis if an event occurs or circumstances change that would more likely than not reduce the fair value of our reporting units below their carrying amount.

Restructuring Expenses.In the past five years, we have implemented cost-reduction plans as part of our continued effort to streamline our operations to reduce ongoing operating expenses. These plans resulted in restructuring expenses related to, among others, the consolidation of excess facilities. These charges relate to facilities and portions of facilities we no longer utilize and either seek to terminate early or sublease. Lease termination costs and brokerage fees for the abandoned facilities were estimated for the remaining lease obligations and were offset by estimated sublease income. Estimates related to sublease costs and income are based on assumptions regarding the period required to locate and contract with suitable sub-lessees and sublease rates which can be achieved using market trend information analyses provided by a commercial real estate brokerage retained by us. Each reporting period we review these estimates and to the extent that these assumptions change due to new agreements with landlords, new subleases with tenants, or changes in the market, the ultimate restructuring expenses for these abandoned facilities could vary by material amounts.

Determining Functional Currencies for the Purpose of Consolidation.We have several foreign subsidiaries that together account for a significant portion of our revenues, expenses, assets and liabilities.

In preparing our Condensed Consolidated Financial Statements, we are required to translate the financial statements of the foreign subsidiaries from the currency in which they keep their accounting records, generally the local currency, into United Statesdollars. This process results in exchange gains and losses which, under the relevant accounting guidance are either included within theCondensed Consolidated Statement of Operations or as a separate part of our net equity under the caption "Accumulated Other Comprehensive Income." Under the relevant accounting guidance, the treatment of these translation gains or losses is dependent upon our management's determination of the functional currency of each subsidiary. The functional currency is determined based on management's judgment and involves

consideration of all relevant economic facts and circumstances affecting the subsidiary. Generally, the currency in which the subsidiary conducts a majority of its transactions, including billings, financing, payroll and other expenditures would be considered the functional currency but any dependency upon the parent and the nature of the subsidiary's operations must also be considered.

If any subsidiary's functional currency were deemed to be the local currency, then any gain or loss associated with the translation of that subsidiary's financial statements would be included in cumulative translation adjustments. However, if the functional currency were deemed to be the United Statesdollar then any gain or loss associated with the translation of these financial statements would be included within our Condensed Consolidated Statement of Operations. If we dispose of any of our subsidiaries, any cumulative translation gains or losses would be recognized in our Condensed Consolidated Statement of Operations. If we determine that there has been a change in the functional currency of a subsidiary to the United Statesdollar, any translation gains or losses arising after the date of change would be included within our Condensed Consolidated Statement of Operations.

Based on our assessment of the factors discussed above, we consider the relevant subsidiary's local currency to be the functional currency for each of our international subsidiaries. Accordingly, foreign currency translation gains and loses are included as part of Accumulated Other Comprehensive Income within our Condensed Consolidated Balance Sheetsfor all periods presented.

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The magnitude of these gains or losses is dependent upon movements in the exchange rates of the foreign currencies in which we transact business against the United Statesdollar. These currencies include the United Kingdom Pound Sterling, the Euro and the Canadian Dollar. Any future translation gains or losses could be significantly higher than those reported in previous periods. At December 31, 2007, approximately $48.3 million of our cash and cash equivalents were held by our subsidiaries outside of the United States.

Recent Accounting Pronouncements

See Note 2 to the Condensed Consolidated Financial Statements under section "Recent Accounting Pronouncements" for detailed information regarding status of new accounting standards that are not yet effective for us.

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Results of Operations

The following table sets forth, in dollars(in thousands)and as a percentage of total revenues, unaudited Condensed Consolidated Statements of Operations data for the periods indicated. This information has been derived from the Condensed Consolidated Financial Statements included elsewhere in this Quarterly Report.

	Three Months Ended December 31,			
	2007		2006	
Statements of Operations Data:				
Revenues:				
License	$ 8,807	30%	$ 7,162	31%
Service	20,327	70	15,777	69
Total revenue	29,134	100	22,939	100
Cost of revenue:				
License	334	1	454	2
Service	8,478	29	7,466	33
Amortization of intangible assets	303	1	303	1
Total cost of revenue	9,115	31	8,223	36
Gross profit	20,019	69	14,716	64
Operating expenses:				
Sales and marketing	8,903	31	7,264	32
Research and development	6,725	23	6,296	27
General and administrative	5,003	17	5,611	25
Restructuring expense	—	—	6,472	28
Total operating expense	20,631	71	25,643	112
Loss from operations	(612)	(2)	(10,927)	(48)
Interest income, net	835	3	304	1
Other income (expense), net	134	—	(15)	(—)
Income (loss)before income taxes	357	1	(10,638)	(47)
Provision for income taxes	152	—	111	—
Net income (loss)	$ 205	1%	$ (10,749)	(47)%

Comparison of the Three Months Ended December 31, 2007and 2006(Unaudited)

Revenues

Total revenues increased $6.2 million, or 27%, to $29.1 million for the three months ended December 31, 2007 as compared to the same period of the prior year.This increase was primarily due to a 23%increase in license revenue and a 29% increase in servicerevenue.

The following summarizes the components of our total revenues:

License Revenue

The increase or decrease of license revenue occurring within the three different product groupsis dependent on the timing of when a sales transaction iscompleted and whether a license transaction was sold with essential consulting services. Products licensedwith essential consulting services are generally recognized as revenue under the percentage-of-completion method of accounting. The timing and amount of revenue for those transactions being recognized under the percentage-of-completion method is influenced by the progress of work performed relative to the

project length of customer contracts and the dollar value of such contracts. The following table sets fourth our license revenue by product emphasis for the three months ended December 31, 2007and 2006 (in thousands, except percentages):

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	Three Months Ended December 31,			
License Revenue:	2007	2006	Change	%
Enterprise solutions	$ 6,214	$ 3,545	$ 2,669	75%
Marketing solutions	714	989	(275)	(28)
Decision management solutions	1,879	2,628	(749)	(29)
Total license revenue	$ 8,807	$ 7,162	$ 1,645	23%

Total license revenue increased by $1.6 million or 23% for the three months ended December 31, 2007as compared to the same period of the prior year. The increase is attributed to the number of projects and the degree of progress associated with percentage-of-completion transactions.

Service Revenue

Service revenue isprimarily composed of consulting implementation and integration, consulting customization, training, post-contract customer support services, or PCS, and certain reimbursable out-of-pocket expenses. The increase or decrease of service revenue within the three different product emphases is primarily due to the timing of when license transactions are completed, whether or not the license was sold with essential consulting services, the sophistication of the customer's application, and the expertise of the customer's internal development team. For otherservice transactions, service revenue will lag in timing compared to the period of when the license revenue is recognized. The following table sets forth our service revenue by product emphasis for the three months ended December 31, 2007and 2006 (in thousands, except percentages):

	Three Months Ended December 31,			
Service Revenue:	2007	2006	Change	%
Enterprise solutions	$ 15,209	$ 12,199	$ 3,010	25%
Marketing solutions	3,118	2,605	513	20
Decision management solutions	2,000	973	1,027	106
Total service revenue	$ 20,327	$ 15,777	$ 4,550	29%

Total service revenue increased$4.6 million or 29% for the three months ended December 31, 2007, as compared to the same period of the prior year. The$4.6 million increase is primarily related to increases of $3.0million in PCSrevenue, $1.2 million in consulting revenue, $0.3 million in training revenue and $0.1 million in reimbursement of out-of-pocket expense revenue.The increase in PCSrevenueis a function of the growth in new license transactions sold with PCS agreements combined with the renewal of existing PCS customers at a rate in excess of existing customers declining PCS at some point in time after the first year. The increase in consulting revenue is a direct result of the growth in license revenue as the majority of our customers will use some form of our consulting services in connection with their project.

Cost of Revenue

License

Cost of license revenues includes third partysoftware royalties and amortization of capitalized software development costs. Royalty expenses can vary depending upon the mix of products sold within the period. The capitalized software development costsprimarilypertain to a banking product that was completed and available for general release in August 2005 and the third party costs associated with the porting of a product to a new platform. The porting project was completed in August 2007 and the aggregate costs capitalized were $0.5 million. Amortization expense for the banking product and porting project for the three months ended December 31, 2007 were$0.2 million and less than

$0.1 million, respectively. Amortization costs for the banking product are expectedthrough 2008and amortization costs of the porting project are expected through 2010. The following table sets forth our cost of license revenues for the three months ended December 31, 2007and 2006 (in thousands, except percentages):

	Three Months Ended December 31,			
	2007	2006	Change	%
Cost of license revenue	$ 334	$ 454	$ (120)	(26)%
Percentage of total revenue	1%	2%		

Cost of licenserevenue decreasedby $0.1 million or 26% from the three months ended December 31, 2006 as compared to the same period of the prior year. The decrease is primary due to the reduction in royalty expense associated with third party technology included in our products.

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Service

Cost of service revenues consists primarily of personnel, third party consulting, facility and travel costs incurred to provide consulting implementation and integration, consulting customization, training, PCS support services. The following table sets forth our cost of service revenues for the three months ended December 31, 2007 and 2006 (in thousands, except percentages):

	Three Months Ended December 31,			
	2007	2006	Change	%
Cost of service revenue	$ 8,478	$ 7,466	$ 1,012	14%
Percentage of total revenue	29%	33%		

Cost of service revenue increased $1.0 million or 14% for the three months ended December 31, 2007, as compared to the same period of the prior year.This change is primarily due to an increase in third party consulting costs of $1.2 million offset by adecreasein personnel and related costs of $0.2 million associated with a decrease in headcount. Service costs increased at a lower rate as compared to the increase in service revenue due to improved utilization of our internal consultant teams, replacing full time employees with third party consultants (converting a fixed cost to a variable cost) and increasing PCS revenue, which to a limited degree is not based on a variable cost model, so there is not a direct relationship of revenue to costs.

Amortization of Intangible Assets

Amortization of intangible assets cost consists primarily of the amortization of amounts paid for developed technologies, customer lists and trade-names resulting from business acquisitions. The following table sets forth our costs associated with amortization of intangible assets for the three months ended December 31, 2007 and 2006 (in thousands, except percentages):

	Three Months Ended December 31,			
	2007	2006	Change	%
Amortization of intangible assets	$ 303	$ 303	$ —	—%
Percentage of total revenues	1%	1%		

We expect amortization expense forintangible assets to be $0.3 million for each of the three remaining quarters in fiscal year 2008, $1.2 million in fiscal year 2009 and $0.3 million in fiscalyear2010.

Operating Expenses

Sales and Marketing

Sales and marketing expense is attributed to activities associated with selling, promoting and advertising our products, product demonstrations and customer sales calls. These costs consist primarily of employee salaries, commissions and bonuses, benefits, facilities, travel expenses and promotional and advertising expenses. The following table sets forth our sales and marketing expenses for the three months ended December 31, 2007 and 2006 (in thousands, except percentages):

	Three Months Ended December 31,			
	2007	2006	Change	%
Sales and marketing expense	$ 8,903	$ 7,264	$ 1,639	23%

Percentage of total revenues	31%	32%

Sales and marketing expense increased by $1.6 million or 23% forthe three months ended December31, 2007 as compared to the same period of the prior year. The increase is primarily due to increases of $1.0 million in sales and marketing program costs, $0.4 million in personnel and related costs and $0.2 million in consultant costs. The increase in sales and marketing program costs was mainly attributed to two annual worldwide sales events: Sales Kick Off and Presidents Club. In the prior year, these events occurred in the March 2007 quarter.

Research and Development

Research and development expense results from the activities associated with the development of new products, enhancements of existing products and quality assurance activities. These costs consist primarily of employee compensation, benefits, facilities, the cost of software and development tools, equipment and consulting costs, including costs for offshore consultants. The following table sets forth our research and development expenses for the three months ended December 31, 2007 and 2006 (in thousands, except percentages):

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	Three Months Ended December 31,			
	2007	2006	Change	%
Research and development expense	$ 6,725	$ 6,296	$ 429	7%
Percentage of total revenues	23%	27%		

Research and development expense increased by $0.4 million or 7% for the three months ended December 31, 2007 as compared to the same period of the prior year. The increase is primarily related to increases of $0.3 million for personnel and related costs and $0.1 million in outsourced research and development expenses. The increase in personnel costs was driven by a 17% increase in average headcount for the comparative periods.

General and Administrative

General and administrative expense results from activities managed byour executive and administrative personnel (e.g. the CEO, legal, human resourcesand finance personnel). These costs consist primarily of employee compensation, bonuses, stock-based compensation expense, benefits, facilities, consulting, legal and auditcosts, including costs for Sarbanes-Oxley Act of 2002 (SOX) compliance. The following table sets forthour general and administrative expenses for the three months ended December 31, 2007and 2006 (in thousands, except percentages):

	Three Months Ended December 31,			
	2007	2006	Change	%
General and administrative expense	$ 5,003	$ 5,611	$ (608)	(11)%
Percentage of total revenues	17%	25%		

General and administrative expense decreased by $0.6 million or 11% for the three months ended December 31, 2007, as compared to the same period of the prior year. The decrease isprimarily due to a decrease of $0.7 million in professional services mainly associated with the stock option investigation that occurred in the prior year. The investigation and its associated costs were completed by March 2007. This decrease in costs was offset by an increase of $0.2 million in travel related costs.

Restructuring Expense

In October 2006, we initiated a restructuring plan that included an immediate reduction in positions of slightly more than ten percent of the Company's workforce, consolidation of our European facilities, and the closure of our French office. A majority of the positions eliminated were in Europe. For the three months ended December 31, 2006, we initially recorded a pre-tax cash restructuring expense of $6.5 million as calculated using the net present value of the related costs as required by SFAS 146. The expense was composed of $1.7 million for severance costs and $4.8 million for exiting excess facilities of which $1.0 million of the excess facility expense was associated with non-cash charges for the write-off of leasehold improvements and the reversal of a favorable purchase price adjustment related to the France office lease. Subsequent to December 31, 2007 and as of the date of the filing of this Form 10-Q, all liabilities associated with this restructuring expense has been paid.

Stock-based Compensation (included in Individual Operating Expense and Cost of Revenue categories)

The following table sets forthour stock-based compensation expense and functional breakdown for the three months ended December 31,2007 and 2006 (in thousands):

	Three Months Ended December 31,	
	2007	2006

Cost of revenues- service	$	153	$	107
Operating expenses:				
Sales and marketing		241		329
Research and development		199		93
General and administrative		582		447
Total operating expense		1,022		869
Total stock-based compensation expense	$	1,175	$	976

For the three months ended December 31, 2007, the aggregate stock-based compensation cost included in cost of revenues and in operating expenses was $1.2 million and primarily related to $0.9 million associated with employee stock options and $0.3 million associated with restricted stock units. For the three months ended December 31, 2006, the aggregate stock-based compensation cost included in cost of revenues and in operating expenses was $1.0 million and primarily related to $0.8 million associated with employee stock options and $0.2 million associated with restricted stock awards.

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Interest Income, Net

Interest income, net, consists primarily of interest income generated from our cash, cash equivalents, restricted cash and marketable securities, offset by interest expense incurred in connection with our capital leases,letters of credit and imputed under SFAS 146 restructuring accruals. The following table sets forth our interest income, net for the three months ended December 31, 2007 and 2006 (in thousands, except percentages):

	Three Months Ended December 31,			
	2007	2006	Change	%
Interest income, net	$ 835	$ 304	$ 531	175%
Percentage of total revenues	3%	1%		

Interest income, net increased by $0.5 million or 175% forthe three months ended December 31, 2007, as compared to the same period of the prior year. This increase is primarilydue to the Company transferring a portion of its funds into marketable securities which earn a higher return of interest than other investments we utilized in the prior year.

Other Income (Expense), Net

Other income (expense), net isprimarily attributed toforeign currency transaction gains or losses and re-measurement of our short-term intercompany balances between the U.S.and our foreign denominated subsidiaries. The following table sets forthour other income (expense), net for the three months ended December 31, 2007and 2006 (in thousands, except percentages):

	Three Months Ended December 31,			
	2007	2006	Change	%
Other income (expense), net	$ 134	$ (15)	$ 149	993%
Percentage of total revenues	—%	—%		

Other income (expense) increasedby $0.1 million or 993% forthe three months ended December 31,2007, as compared to the same period of the prior year. This increase was primarily related to the selling of a website domain name during the three months ended December 31, 2007. This was a non-recurring transaction and not considered part of our normal business operations.

Provision for Income Taxes

Our provision for income taxes was $0.2 million and $0.1 million for the three months ended December 31, 2007 and 2006, respectively. These provisions are primarily attributable to taxes on earnings from our foreign subsidiaries,certain foreign withholding taxes, minimum taxes at the state level, and the alternate minimum tax for federal purposes.

Our deferred tax assets primarily consist of net operating loss carryforwards, nondeductible allowances and research and development tax credits. We have recorded a valuation allowance for the full amount of our net deferred tax assets, as the future realization of the tax benefit is not considered by management to be more-likely-than-not.

Liquidity and Capital Resources

Prior to fiscal 2007,we have not been profitable and we have financed any shortfall from our operating activities through the issuance of our common stock. For the three months ended December 31, 2007, we used cash from

operations, but generated cash from financing and investing activities. It is anticipated that we will generate cash from operations or financing activities in excess of the cash requirements for the next twelve months.

Operating Activities

Cash used by operating activities was $2.7 million during the three months ended December 31, 2007, which consisted primarily of our net income of $0.2 million adjusted for non-cash items (primarily depreciationandamortization, non-cash stock-based compensation expense, and the provision for doubtful accounts) aggregating approximately $2.1 million and the net cash outfloweffect from changes in assets and liabilities of approximately $5.0 million. This net cash outflow was primarilydueto the change in account balances in deferred revenue of $10.7 million, in prepaid expenses and other current assets of $2.0 million, offset by cash inflows from the change in account balances in accounts receivable of $6.3 million, in other assets of $1.0 million and in accrued expenses and accounts payable of $0.4 million.

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Cash provided by operating activities was $2.4 million during the three months ended December 31, 2006, which consisted primarily of our net loss of $10.7 million adjusted for non-cash items (primarily depreciation and amortization, non-cash stock-based compensation expense,provision for doubtful accounts, loss on disposal of assets and other non-cash charges) aggregating approximately $2.9 million and the net cash inflow effect from changes in assets and liabilities of approximately $10.2 million. This net cash inflow was primarily related to the timing of payments for vendor invoices and other accrued liabilities and an increase in deferred revenues of $31.7 million. The increase in deferred revenues is the result of two large sales transactions totaling $34.0 million that were consummatedduring the period for which revenue was notrecognized until subsequent periods. This increase corresponds with an increase in accounts receivable of $22.7 million primarily related to sales transactions that closed at the end of the quarter not allowing sufficient time within the quarter to collect the cash.

Investing Activities

Cash provided byinvesting activities was $0.5 million during the three months ended December 31, 2007. The cash provided wasprimarily from $1.3 million of net proceeds from marketable securities offset by the use of cash for the purchase of $0.7 million of property and equipment,and the capitalization of less than $0.1 million of software development costs associated with the porting of an existing product to a new platform. The property and equipment purchases were primarily computer equipment and software used in day-to-day operations.

Cash used for investing activities was $1.1 million during the three months ended December 31, 2006. This use of cash was primarily for purchases of property and equipment associated with the closure of the previousEuropean headquarters office and the opening of the new smaller European headquarters office during the period.

Financing Activities

Cash provided by financing activities was $0.6 million during the three months ended December 31, 2007. The cash provided wasprimarily related to proceeds from stock option exercises of $0.6 million and less than $0.1 million from excess tax benefits from stock-based compensation.

Cash provided by financing activities was $0.2 million during the three months ended December 31, 2006. The cash provided wasprimarily related to proceeds from stock option exercises of $0.2 million, offset by payments of $0.1 million on capital lease obligations.

Revolving Line of Credit

See Note 8 to the Condensed Consolidated Financial Statements for detailed information regarding our revolving line of credit.

Contractual Obligations

Ness

We entered into an agreement with Ness Technologies Inc., Ness Global Services, Inc. and Ness Technologies India, Ltd. (collectively, “Ness”), effective December 15, 2003, pursuant to which Ness provides our customers with technical product support through a worldwide help desk facility, a sustaining engineering function that serves as the interface between technical product support and our internal engineering organization, product testing services and product development services (collectively, the “Services”). The agreement had an initial term of three years and was extended for twoadditional year terms. Under the terms of the agreement, wepay for services rendered on a monthly fee basis,

including the requirement to reimburse Nessfor approved out-of-pocket expenses. The agreement may be terminated for convenience by us, subject to the payment of a termination fee. In 2004, 2005, 2006 and 2007 wefurther expanded ouragreement with Ness whereby Nessis providing certain additional technical and consulting services. The additional agreements canbe cancelled at the option of uswithout the payment of a termination fee. The remaining minimum purchase commitment under these agreements, if Chordiant was to cancel the contracts, was approximately $0.7 million at December 31, 2007. In addition to service agreements, we also guaranteed certain equipment lease obligations of Ness (see Note 9 to the Condensed Consolidated Financial Statements). Nessmay procure equipment to be used in performance of the Services, either through leasing arrangements or direct cash purchases, for which we areobligated under the agreement to reimburse them. In connection with the procurement of equipment, Ness has entered into a 36 month equipment lease agreement with IBM India and, in connection with the lease agreement wehave an outstandingstandby letter of credit in the amount of $0.3 million in guarantee of Ness' financial commitments under the lease. Over the term of the lease, our obligation to reimburse Nessis approximately equal to the amount of the guarantee.

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Leases

Operating lease payments in the table belowinclude approximately $3.4 million for two facility operating lease commitments that are included in Restructuring expenses. One of the leases is located in Boston, Massachusetts and the other is located in the United Kingdom. As of December 31, 2007, the Company has $0.8 million insublease income contractually committed for future periods relating to the Boston, Massachusetts facility classified as an operating lease. See Notes 5 and 9 to the Condensed Consolidated Financial Statements for further discussion.

In November 2007, we negotiated a break clause in the in the United Kingdom lease allowing for an early termination of the respective facility which will release the Company of any future rent liabilities subsequent to January 2008. The scheduled lease paymentsshown in the table below includes $1.2 million that was paid in the second quarter of fiscal year 2008 associated with the early termination of the United Kingdomlease. Subsequent to December 31, 2007 and as of the date of the filing of this Form 10-Q, the Company has paid its final lease payment for the United Kingdomlease and has been released from any future rent liabilities.

We haveasset retirement obligations,associated with commitments to return property subject to operating leases to original condition upon lease termination. Asof December 31, 2007, weestimate that gross expected cash flows of approximately $0.4 million will be required to fulfill these obligations

We have no material commitments for capital expenditures and do not anticipate capital expenditures to fluctuate significantly from historic levels.

The following table presents certain payments due under contractualobligations as of December 31, 2007 based on fiscal years (in thousands):

	Payments Due By Period				
	Total	Due in 2008	Due in 2009-2010	Due in 2011-2012	Thereafter
Operating lease obligations	$ 11,428	$ 3,619	$ 4,779	$ 2,473	$ 557
Asset retirement obligations	350	—	—	350	—
Total	$ 11,778	$ 3,619	$ 4,779	$ 2,823	$ 557

Effective October 1, 2007, the Company adopted FIN No. 48 and reclassified $0.2 million of gross unrecognized tax benefits to Other Long-Term Liabilities in our Condensed Consolidated Balance Sheets. As of December 31, 2007, the Company cannot make a reasonably reliable estimate of the period in which these liabilities may be settled with the respective tax authorities. See Note 11 to the Condensed Consolidated Financial Statements for additional information.

We believe that the effects of our strategic actions implemented to improve revenue as well as to control costs will be adequate to generate sufficient cash flows from operations, which, when combined with existing cash balances, we anticipate will be sufficient to meet our working capital and operating resource expenditure requirements for the near term. If the global economy weakens, a decline could occur.

We anticipate that operating expenses will continue to be a material use of our cash resources. We may continue to utilize cash resources to fund acquisitions or investments in other businesses, technologies or product lines. In the long-term, we may require additional funds to support our working capital and operating expense requirements or for other purposes, and may seek to raise these additional funds through public or private debt or equity financings. There can be no assurance that this additional financing will be available, or if available, will be on reasonable terms. Failure to generate sufficient revenues or to control spending could adversely affect our ability to achieve our business

objectives.

Indemnification

See Note 9 to the Condensed Consolidated Financial Statements for detailed information regarding our indemnifications.

Off Balance Sheet Arrangements

None.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk.

We are exposed to the impact of interest rate changes and foreign currency fluctuations.

The following table presents the amounts of restricted cashand marketable securitiesthat are subject to interest rate risk by year of expected maturity and average interest rates as of December 31, 2007 (in thousands):

	December 31, 2007	Fair Value	Average Interest Rates
Restricted cash invested in short-term investments	$ 315	$ 315	2.8%
Marketable securities	10,885	10,885	4.6%
Total restricted cash and marketable securities	$ 11,200	$ 11,200	4.6%

The following table presents the amounts of restricted cash that are subject to interest rate risk by year of expected maturity and average interest rates as of December 31, 2006(in thousands):

	December 31, 2006	Fair Value	Average Interest Rates
Restricted cash invested in short-term investments	$ 602	$ 602	1.6%

Interest Rate Risk. Our exposure to market rate risk for changes in interest rates relates primarily to money market accounts, commercial paper, short-term certificates of depositand marketable securities. We invest our excess cash in money market accounts, commercial paper, certificates-of-deposit, and marketable securitieswith maturities of less than one year.Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell our fixed rate securities which have declined in market value due to changes in interest rates.

To provide a meaningful assessment of the interest rate risk associated with the Company's total restricted cash and marketable securities, we performed a sensitivity analysis to determine the hypothetical impact of a decrease in interest rate of 100 basis points. Assuming consistent investment levels as of December 31, 2007, interest income would decline by less than $0.1 million. Assuming consistent investment levels as of December 31, 2006, interest income would have declined by less than $0.1 million.

Foreign Currency Risk. International revenues accounted for approximately 46% and 42% of total revenues for three months ended December 31, 2007 and 2006, respectively. International revenues increased $3.8 million or 39% compared to the same period of the prior year. The growth in our international operations has increased our exposure to foreign currency fluctuations. Revenues and related expense generated from our international subsidiaries are generally denominated in the functional currencies of the local countries. Primary currencies include the United Kingdom Pound Sterling, the Euro and the Canadian Dollar. The Condensed Consolidated Statement of Operations is translated into United States Dollars at the average exchange rates in each applicable period. To the extent the United States Dollar strengthens against foreign currencies, the translation of these foreign currencies denominated

transactions results in reduced revenues, operating expense, and net income for our international operations. Similarly, our revenues, operating expenses, and net income will increase for our international operations, if the United States Dollar weakens against foreign currencies. Using the average foreign currency exchange rates for the three months ended December 31, 2006, our international revenues for the three months ended December 31, 2007 would have been lower than we reported by approximately $1.1 million and our international income from operations would have been lower than we reported by $0.4 million.

We are also exposed to foreign exchange rate fluctuations as we convert the financial statements of our foreign subsidiaries and our investments in equity interests into United Statesdollars in consolidation. If there is a change in foreign currency exchange rates, the conversion of the foreign subsidiaries' financial statements into United Statesdollars will lead to a translation gain or loss which is recorded as a component of accumulated other comprehensive income which is a componentof Stockholders' Equity. In addition, we have certain assets and liabilities that are denominated in currencies other than the relevant entity's functional currency. Changes in the functional currency value of these assets and liabilities create fluctuations that will lead to a transaction gain or loss. For the three months ended December 31, 2007 and 2006, we recorded net foreign currency transaction gains (losses), realized and unrealized, of less than $0.1 million which was recorded in Other income (expense), net, in the Condensed Consolidated Statements of Operations.

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Item 4. Controls and Procedures.

Under the supervision and with the participation of our management, including the President and Chief Executive Officer and the Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act of 1934, as amended, Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended December 31, 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

See Note 10 to the Condensed Consolidated Financial Statements in Part 1, Item 1 of this Form 10-Q for a description of our legal proceedings.

Item 1A.

RISK FACTORS

The Company has marked with an asterisk (*) those risk factors that reflect substantive changes from the risk factors included in the Company's Form 10-K filed with the Securities and Exchange Commission for the fiscal year ended September 30, 2007.

The matters relating to the Audit Committee of the Board's review of our historical stock option granting practices and the restatement of our Consolidated Financial Statements have resulted in litigation, and may result in additional litigation.

On July 24, 2006, the Company announced that the Audit Committee of the Company's Board of Directors, with the assistance of independent legal counsel, was conducting a review of our stock option practices covering the time from the Company's initial public offering in 2000 through June 2006. As described in Note 3 "Restatement of Previously Issued Consolidated Financial Statements" in Notes to Consolidated Financial Statements in the 2006 Form 10-K, the Audit Committee reached a conclusion that incorrect measurement dates were used for financial accounting purposes for stock option grants in certain prior periods. As a result, the Company has recorded additional non-cash stock-based compensation expense, and related tax effects, related to certain stock option grants, and the Company has restated certain previously filed financial statements included in the 2006 Annual Report on Form 10-K.

This review of our historical stock option granting practices has required us to incur substantial expenses for legal, accounting, tax and other professional services, has diverted our management's attention from our business, and any litigation or future government enforcement actions could in the future adversely affect our business, financial condition, results of operations and cash flows.

Our historical stock option granting practices and the restatement of our prior financial statements have exposed us to greater risks associated with litigation proceedings. Several derivative complaints have been filed pertaining to allegations relating to stock option grants. We cannot assure you that these or future similar complaints or any future litigation or regulatory action will result in the same conclusions reached by the Audit Committee. The conduct and resolution of these matters will be time consuming, expensive and distracting from the conduct of our business.

We contacted the SEC regarding the Audit Committee's review and, in July 2006, the SEC commenced an investigation into our historical stock option grant practices. In November 2006, a representative of the Audit Committee and its informal advisors met with the enforcement staff of the SEC and provided them with a report of the Audit Committee's investigation and findings. In January 2007, the enforcement staff of the SEC notified the Company that its investigation had been terminated and no enforcement action had been recommended to the Commission.

The findings of the Audit Committee's review are more fully described in Note 3 to the Consolidated Financial Statements and in Item 9A of the Annual Report on Form 10-K for the year ended September 30, 2006.

*Prior to the three months ended March 31, 2007, we were not profitable and we may incur losses in the future, which may raise vendor viability concerns thereby making it more difficult to close license transactions with new and existing customers.

While the Company was profitable in the amount of $0.2 million for the three months ended December 31, 2007, we incurred a loss of $10.7 million for the three months ended December 31, 2006. As of December 31, 2007, we had an accumulated deficit of $226.7million. We may incur losses in future periods and cannot be certain that we can generate sufficient revenues to achieve profitability. Continued losses may leave many customers reluctant to enter into new large value license transactions without some assurance that we will operate profitably. If we fail to enter into new large value license transactions due to lack of vendor profitability and/or viability concerns, our revenues will decline, which could further adversely affect our operating results.

*Because a small number of customers account for a substantial portion of our revenues, the loss of a significant customer could cause a substantial decline in our revenues.

We derive a significant portion of our license and service revenues from a limited number of customers. The loss of a major customer could cause a decrease in revenues and net income. For the three months ended December 31, 2007, Citicorp Credit

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Services, Inc.,IBM, and Wellpoint, Inc., accounted for 22%, 11% and 11% of our total revenue. While our customer concentration has fluctuated, we expect that a limited number of customers will continue to account for a substantial portion of our revenues. As a result, if we lose a major customer, or if a contract is delayed or cancelled or we do not contract with new major customers, our revenues and net incomewould be adversely affected. In addition, customers that have accounted for significant revenues in the past may not generate revenues in any future period, causing our failure to obtain new significant customers or additional orders from existing customers to materially affect our operating results.

*If we fail to adequately address the difficulties of managing our international operations, our revenues and operating expenses will be adversely affected.

For the quarter ended December 31, 2007, international revenues were $13.5 million or approximately 46% of our total revenues. While North American revenues continue to represent a majority ofour overall revenues, international revenues will continue to represent a significant portion of our total revenues in future periods. We have faced, and will continue to face, difficulties in managing international operations which include:

- Difficulties in hiring qualified local personnel;
- Seasonal fluctuations in customer orders;
- Longer accounts receivable collection cycles;
- Expenses associated with licensing products and servicing customers in foreign markets;
- Economic downturns and political uncertainty in international economies;
- Income tax withholding issues in countries in which we do not have a physical presence, resulting in non-recoverable tax payments;
- Complex transfer pricing arrangements between legal entities;
- Doing business and licensing our software to customers in countries with weaker intellectual property protection laws and enforcement capabilities;
- Difficulties in commencing new operations in countries where the Company has not previously conducted business, including those associated with tax laws, employment laws, government regulation, product warranty laws and adopting to local customs and culture; and

Any of these factors could have a significant impact on our ability to license products on a competitive and timely basis and could adversely affect our operating expenses and net income. Additionally we closed our only French office in the first fiscal quarter of 2007. The absence of a business office in Francemay harm our ability to attract and retain customers in that country.

Our known backlog of business may not result in revenue.

An increasingly material portion of our revenues has been derived from large orders, as major customers deployed our products. We define backlog as contractual commitments by our customers through purchase orders or contracts. Backlog is comprised of software license orders which have not been accepted by customers or have not otherwise met all of the required criteria for revenue recognition, deferred revenue from customer support contracts, and

deferred consulting and education orders for services not yet completed or delivered. Backlog is not necessarily indicative of revenues to be recognized in a specified future period. There are many factors that would impact the Company's filling of backlog, such as the Company's progress in completing projects for its customers and Chordiant's customers' meeting anticipated schedules for customer-dependent deliverables. The Company provides no assurances that any portion of its backlog will be filled during any fiscal year or at all or that its backlog will be recognized as revenues in any given period. In addition, it is possible that customers from whom we expect to derive revenue from backlog will default and as a result we may not be able to recognize expected revenue from backlog.

*Fluctuations in the value of the U.S. dollar relative to foreign currencies could make our products less competitive in international markets and could negatively affect our operating results and cash flows.

A significant portion of our sales and operating expenses result from transactions outside of the U.S., often in foreign currencies. These currencies include the United Kingdom Pound Sterling, the Euro and the Canadian Dollar. Our international sales comprised 46% of our total sales for the three months ended December 31, 2007. Our international sales comprised 42% of our total sales for the three months ended December 31, 2006. Our future operating results will continue to be subject to fluctuations in foreign currency rates, especially if international sales increase as a percentage of our total sales, and we may be negatively impacted by fluctuations in foreign currency rates in the future. For the three months ended December 31, 2007, we had an unrealized foreign currency transaction gain of less than $0.1 million. See Item 3 Quantitative and Qualitative Disclosures about Market Risk for further discussions.

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Geopolitical concerns could make the closing of license transactions with new and existing customers difficult.

Our revenues will decrease in fiscal year 2008or beyond if we are unable to enter into new large-scale license transactions with new and existing customers. The current state of world affairs and geopolitical concerns have left many customers reluctant to enter into new large value license transactions without some assurance that the economy both in the customer's home country and worldwide will have some economic and political stability. Geopolitical instability will continue to make closing large license transactions difficult. In addition, we cannot predict what effect the U.S. military presence overseas or potential or actual political or military conflict have had or are continuing to have on our existing and prospective customers' decision-making process with respect to licensing or implementing enterprise-level products such as ours. Our ability to enter into new large license transactions also directly affects our ability to create additional consulting services and maintenance revenues, on which we also depend.

Competition in our markets is intense and could reduce our sales and prevent us from achieving profitability.

Increased competition in our markets could result in price reductions for our products and services, reduced gross margins and loss of market share, any one of which could reduce our future revenues. The market for our products is intensely competitive, evolving and subject to rapid technological change. Historically, our primary competition has been from internal development, custom systems integration projects and application software competitors. In particular, we compete with:

- Internal information technology departments:in-house information technology departments of potential customers have developed or may develop systems that provide some or all of the functionality of our products. We expect that internally developed application integration and process automation efforts will continue to be a significant source of competition.

- Custom systems integration projects:we compete with large systems integrators who may develop custom solutions for specific companies which may reduce the likelihood that they would purchase our products and services.

- Point application vendors:we compete with providers of stand-alone point solutions for web-based customer relationship management and traditional client/server-based, call-center service customer and sales-force automation solution providers.

The enterprise software industry continues to undergo consolidation in sectors of the software industry in which we operate. Within the last 12 months, IBM acquired Cognos, DataMirror and Watchfire Corporation, Oracle completed its acquisition of Hyperion and Moniforce and has entered into an agreement to purchase BEA systems, Sun Microsystems has entered in an agreement to purchase MySQL and SAP acquired BusinessObjects, YASU Technologies and Pilot Software. While we do not believe that Cognos, DataMirror, Watchfire Corporation, Hyperion, Moniforce, BEA Systems, MySQL, BusinessObjects, YASU Technologies, or Pilot Software have been significant competitors of Chordiant in the past, the acquisition of these companies by IBM, Oracle, Sun Microsystems and SAP may indicate that we will face increased competition from larger and more established entities in the future.

Many of our competitors have greater resources and broader customer relationships than we do. In addition, many of these competitors have extensive knowledge of our industry. Current and potential competitors have established, or may establish, cooperative relationships among themselves or with third parties to offer a single solution and to increase the ability of their products to address customer needs.

*The company's common stock price has historically been and may continue be volatile, which could result in substantial losses for stockholders.

The market price of shares of the Company’s common stock has been and is likely to continue to be highly volatile and may be significantly affected by factors such as the following:

- Actual or anticipated fluctuations in its operating results;
- Changes in economic and political conditions in the United States and abroad;
- Terrorist attacks, war or the threat of terrorist attacks and war;
- The announcement of mergers or acquisitions by the Company or its competitors;
- Developments in ongoing or threatened litigation;
- Announcements of technological innovations;
- Failure to comply with the requirements of Section 404 of the Sarbanes-Oxley Act;

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- New products or new contracts announced by it or its competitors;
- Developments with respect to intellectual property laws;
- Price and volume fluctuations in the stock market;
- Changes in corporate purchasing of software by companies in the industry verticals supported by the Company;
- Adoption of new accounting standards affecting the software industry; and
- Changes in financial estimates by securities analysts.

In addition, following periods of volatility in the market price of a particular company's securities, securities class action litigation has often been brought against such companies. If the Company is involved in such litigation, it could result in substantial costs and a diversion of management's attention and resources and could materially harm the Company's business, operating results and financial condition.

We may experience a shortfall in bookings, revenue, earnings, cash flow or otherwise fail to meet public market expectations, which could materially and adversely affect our business and the market price of our common stock.

Our revenues and operating results may fluctuate significantly because of a number of factors, many of which are outside of our control. Some of these factors include:

- Size and timing of individual license transactions;
- Delay or deferral of customer implementations of our products and subsequent impact on revenues;
- Lengthening of our sales cycle;
- Potential additional deterioration and changes in domestic and foreign markets and economiesincluding those impacted by the difficulties in the sub-prime lending markets;
- Success in expanding our global services organization, direct sales force and indirect distribution channels;
- Timing of new product introductions and product enhancements;
- Appropriate mix of products licensed and services sold;
- Levels of international transactions;
- Activities of and acquisitions by competitors;
- Product and price competition; and
- Our ability to develop and market new products and control costs.

One or more of the foregoing factors may cause our operating expenses to be disproportionately high during any given period or may cause our revenues and operating results to fluctuate significantly. Based upon the preceding factors,

we may experience a shortfall in revenues and earnings or otherwise fail to meet public market expectations, which could materially and adversely affect our business, financial condition, results of operations and the market price of our common stock.

Our operating results and cash flows fluctuate significantly and delays in delivery or implementation of our products or changes in the payment terms with customers may cause unanticipated declines in revenues or cash flow, which could disappoint investors and result in a decline in our stock price.

Our quarterly revenues depend primarily upon product implementation by our customers. We have historically recognized a significant portion of our license and services revenue through the percentage-of-completion method, using labor hours incurred as the measure of progress towards completion of implementation of our products and we expect this practice to continue. The percentage of completion accounting method requires ongoing estimates of progress of complicated and frequently changing technology projects. Documenting the measure of progress towards completion of implementation is subject to potential errors and changes in estimates. As a result, even minor errors or minor changes in estimates may lead to significant changes in accounting results which may be revised in later quarters due to subsequent information and events. Thus, delays or changes in

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customer business goals or direction when implementing our software may adverselyimpact our quarterly revenue. Additionally, we may increasingly enter into term, subscription or transaction based licensing transactions that would cause us to recognize license revenue for such transactions over a longer period of time than we have historically experienced for our perpetual licenses. In addition, a significant portion of new customer orders have been booked in the third month of each calendar quarter, with many of these bookings occurring in the last two weeks of the third month. We expect this trend to continue and, therefore, any failure or delay in bookings would decrease our quarterly revenue and cash flows. The terms and conditions of individual license agreements with customers vary from transaction to transaction. Historically, the Company has been able to obtain prepayments for product in some cases, but more recently we have entered into large transactions with payments from customers due over one or more years. Other transactions link payment to the delivery or acceptance of products. If we are unable to negotiate prepayments of fees our cash flows and financial ratios with respect to accounts receivable would be adverselyimpacted. If our revenues, operating margins or cash flows are below the expectations of the investment community, our stock price is likely to decline.

If we fail to maintain and expand our relationships with systems integrators and other business partners, our ability to develop, market, sell, and support our products may be adversely affected.

Our development, marketing and distribution strategies rely on our ability to form and maintain long-term strategic relationships with systems integrators, in particular, our existing business alliance partners, IBM, and Accenture. These business relationships often consist of joint marketing programs, technology partnerships and resale and distribution arrangements. Although most aspects of these relationships are contractual in nature, many important aspects of these relationships depend on the continued cooperation between the parties. Divergence in strategy, change in focus, competitive product offerings or potential contract defaults may interfere with our ability to develop, market, sell, or support our products, which in turn could harm our business. If either IBM or Accenture were to terminate their agreements with us or our relationship were to deteriorate, it could have a material adverse effect on our business, financial condition and results of operations. In many cases, these parties have extensive relationships with our existing and potential customers and influence the decisions of these customers. A number of our competitors have stronger relationships with IBM and Accenture and, as a result, these systems integrators may be more likely to recommend competitors’ products and services. Within the year IBM acquired Cognos, DataMirror and Watchfire Corporation. While we do not believe that either Cognos, DataMirror or Watchfire Corporation had been a direct competitor of Chordiant in the past, IBM’s acquisition of these companies may indicate that IBM will become a competitor of ours in the future. While the Company currently has good relationship with IBM, this relationship and the Company’s strategic relationship agreement with IBM may be harmed if the Company increasingly finds itself competing with IBM. Our relationships with systems integrators and their willingness to recommend our products to their customers could be harmed if the Company were to be subject to a take over attempt from a competitor of such systems integrators.

If systems integrators fail to properly implement our software, our business, reputation and financial results may be harmed.

We are increasingly relying on systems integrators to implement our products, and this trend may continue. As a result, we have less quality control over the implementation of our software with respect to these transactions and are more reliant on the ability of our systems integrators to correctly implement our software. If these systems integrators fail to properly implement our software, our business, reputation and financial results may be harmed.

Our primary products have a long sales and implementation cycle, which makes it difficult to predict our quarterly results and may cause our operating results to vary significantly.

The period between initial contact with a prospective customer and the implementation of our products is unpredictable and often lengthy, ranging from three to twenty-four months. Thus, revenue and cash receipts could vary significantly from quarter to quarter. Any delays in the implementation of our products could cause reductions in our revenues. The licensing of our products is often an enterprise-wide decision that generally requires us to provide a significant level of education to prospective customers about the use and benefits of our products. The implementation of our products involves significant commitment of technical and financial resources and is commonly associated with substantial implementation efforts that may be performed by us, by the customer or by third-party systems integrators. If we underestimate the resources required to meet the expectations we have set with a customer when we set prices, then we may experience a net losson that customer engagement. If this happens with a large customer engagement, then this could have a material adverse effect on our financial results. Customers generally consider a wide range of issues before committing to purchase our products, including product benefits, ability to operate with existing and future computer systems, vendor financial stability and longevity, ability to accommodate increased transaction volume and product reliability.

If we do not maintain effectiveinternal controlsover financial reporting, investors could lose confidence in our financial reporting and customers may delay purchasing decisions, which would harm our business and the market price of our common stock.

Effective internal controls are necessary for us to provide reliable financial reports. If we cannot provide reliable financial reports, our business could be harmed. We are a complex company with complex accounting issues and thus subject to related

risks of errors in financial reporting which may cause problems in corporate governance, the costs of which may outweigh the costs of the underlying errors themselves. For example, the Audit Committee of the Company's Board of Directors, with the assistance of outside legal counsel, conducted a review of our stock option practices covering the time from the Company's initial public offering in 2000 through September 2006. The Audit Committee reached a conclusion that incorrect measurement dates were used for financial accounting purposes for stock option grants in certain prior periods. As a result, the Company recorded an additional non-cash stock-based compensation expense, and related tax effects, related to stock option grants and concluded that a material weakness surrounding the control activities relating to the stock option grants existed at September 30, 2006. To correct these accounting errors, we restated the Consolidated Financial Statements contained in our Annual Report on Form 10-K for the year ended September 30, 2006 and our Quarterly Report on Form 10-Q for the three months ended June 30, 2006. As a result of this need to restate financial statements, management and the Audit Committee determined that material weaknesses in our internal control over financial reporting existed as of September 30, 2006. These material weaknesses were remediated during fiscal year 2007 and management concluded internal controls over financial reporting were effective for the reporting period.

If we are not successful in maintainingeffective internal controls over financial reporting, customers may delay purchasing decisions or we may lose customers, create investor uncertainty, face litigation and the market price of our common stock may decline. For more information, please refer to the discussion under the heading "Item 9A. Controls and Procedures" in the 2006Annual Report on Form 10-K.

*If we are not able to successfully manage our partner operations in India, our operations and financial results may be adversely affected.

In 2003, we entered into an agreement with Ness Technologies Inc., Ness Global Services, Inc. and Ness Technologies India, Ltd. (collectively, "Ness"), an independent contracting company with global technical resources and an operations center in Bangalore, India and operations in other locations. The agreement provides for Ness, at our direction, to attract, train, assimilate and retain sufficient highly qualified personnel to perform staffing for consulting projects, technical support, product test and certain sustaining engineering functions. As of December 31, 2007, we use the services of approximately 148 consultants through Ness. In addition, as a result of the reduction in our workforce that took place in July 2005, and the reduction in our workforce that took place in October 2006, by approximately 10% in each instance, we continue to bedependent on Ness. This agreement is an important component of our strategy to address the business needs of our customers and manage our expenses. The success of this operation will depend on our ability and Ness's ability to attract, train, assimilate and retain highly qualified personnel in the required periods. A disruption of our relationship with Nesscould adversely affect our operations. Failure to effectively manage the organization and operations will harm our business and financial results.

If our products do not operate effectively in a company-wide environment, we may lose sales and suffer decreased revenues.

If existing customers have difficulty deploying our products or choose not to fully deploy our products, it could damage our reputation and reduce revenues. Our success requires that our products be highly scalable, and able to accommodate substantial increases in the number of users. Our products are expected to be deployed on a variety of computer software and hardware platforms and to be used in connection with a number of third-party software applications by personnel who may not have previously used application software systems or our products. These deployments present very significant technical challenges, which are difficult or impossible to predict. If these deployments do not succeed, we may lose future sales opportunities and suffer decreased revenues. If we underestimate the resources required to meet the expectations we have set with a customer when we set prices, then we may experience a net loss on that customer engagement. If this happens with a large customer engagement then this could have a material adverse effect on our financial results.

Defects in our products could diminish demand for our products and result in decreased revenues, decreased market acceptance and injury to our reputation.

Errors may be found from time-to-time in our new, acquired or enhanced products. Any significant software errors in our products may result in decreased revenues, decreased sales, and injury to our reputation and/or increased warranty and repair costs. Although we conduct extensive product testing during product development, we have in the past discovered software errors in our products as well as in third-party products, and as a result have experienced delays in the shipment of our new products.

Because competition for qualified personnel is intense, we may not be able to retain or recruit personnel, which could impact the development and sales of our products.

If we are unable to hire or retain qualified personnel, or if newly hired personnel fail to develop the necessary skills or fail to reach expected levels of productivity, our ability to develop and market our products will be weakened. Our success depends largely on the continued contributions of our key management, finance, engineering, sales and marketing and professional services personnel. In particularin prior years, we have had significant turnover of our executives as well in our sales, marketing and finance organizations and many key positions are held by people who have less than two years of experience in their roles with one Company. If these people are not well suited to their new roles, then this could result in the Company having problems in

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executing its strategy or in reporting its financial results. Because of the dependency on a small number of large deals, we are uniquely dependent upon the talents and relationships of a few executives and have no guarantee of their retention. Changes in key sales management could affect our ability to maintain existing customer relationships or to close pending transactions. We have been targeted by recruitment agencies seeking to hire our key management, finance, engineering, sales and marketing and professional services personnel. In addition, in July 2005 and again in October of 2006, we reduced the size of our workforce by approximately 10% in each instance, which may have a negative effect on our ability to attract and retain qualified personnel.

*To date, our sales have been concentrated in the banking, insurance, healthcare, andtelecommunications markets, and if we are unable to continue sales in these markets or successfully penetrate new markets, or if these industries reduce their spending in reaction to the difficulties in the sub-prime lending market, our revenues may decline.

Sales of our products and services in fivelarge markets—banking, insurance, healthcare, telecommunications and retail markets accounted for approximately 97% and 99% of our total revenues for the three months ended December 31, 2007 and 2006, respectively. We expect that revenues from these five marketswill continue to account for a substantial portion of our total revenues for the foreseeable future. If we are unable to successfully increase penetration of our existing markets or achieve sales in additional markets, or if the overall economic climate of our target markets deteriorates, our revenues may decline. Some of our current or prospective customers, especially those in the banking and insurance industries are in businesses that have or could have exposure, directly or indirectly, to the residential mortgage sector or homebuilder sector which has recently been facing financial difficulties. If this causes our current or prospective customers to reduce their spending on technology, then this could have an adverse impact on our sales and revenues.

* Low gross margin in services revenues could adversely impact our overall gross margin and net income.

Our services revenues have had lower gross margins than our license revenues. Service revenues comprised 70% and 69% of our total revenues for the three months ended December 31, 2007 and 2006, respectively. Gross margin on service revenues was 58% and 53% for thethree months ended December 31, 2007 and 2006, respectively. License revenues comprised 30% and 31% of our total revenues for the three months ended December 31, 2007 and 2006, respectively. Gross margins on license revenues were 96% and 94% for the three months ended December 31, 2007and 2006, respectively.

As a result, an increase in the percentage of total revenues represented by services revenues, or an unexpected decrease in license revenues, could have a detrimental impact on our overall gross margins. To increase services revenues, we expect to expand our services organization, successfully recruit and train a sufficient number of qualified services personnel, enter into new implementation projects and obtain renewals of current maintenance contracts by our customers. This expansion could further reduce gross margins in our services revenues.

We may not have the workforce necessary to support our platform of products if demand for our products substantially increased, and, if we need to rebuild our workforce in the future, we may not be able to recruit personnel in a timely manner, which could negatively impact the development,salesand supportof our products.

In July 2005 and again in October of 2006, we reduced the size of our workforce by approximately 10% in each instance. In the event that demand for our products increases, we may need to rebuild our workforce or increase outsourced functions to companies based in foreign jurisdictions and we may be unable to hire, train or retain qualified personnel in a timely manner, which may weaken our ability to market our products in a timely manner, negatively impacting our operations. Our success depends largely on ensuring that we have adequate personnel to support our platform of products as well as the continued contributions of our key management, finance, engineering, sales and marketing and professional services personnel.

If we fail to introduce new versions and releases of functional and scalable products in a timely manner, customers may license competing products and our revenues may decline.

If we are unable to ship or implement enhancements to our products when planned, or fail to achieve timely market acceptance of these enhancements, we may suffer lost sales and could fail to achieve anticipated revenues. We have in the past, and expect in the future, to derive a significant portion of our total revenues from the license of our primary product suite. Our future operating results will depend on the demand for the product suite by future customers, including new and enhanced releases that are subsequently introduced. If our competitors release new products that are superior to our products in performance or price, or if we fail to enhance our products or introduce new features and functionality in a timely manner, demand for our products may decline. We have in the past experienced delays in the planned release dates of new versions of our software products and upgrades. New versions of our products may not be released on schedule or may contain defects when released.

We depend on technology licensed to us by third parties, and the loss or inability to maintain these licenses could prevent or delay sales of our products.

We license from several software providers technologies that are incorporated into our products. We anticipate that we will continue to license technology from third parties in the future. This software may not continue to be available on commercially

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reasonable terms, if at all. While currently we are not materially dependent on any single third party for such licenses, the loss of the technology licenses could result in delays in the license of our products until equivalent technology is developed or identified, licensed and integrated into our products. Even if substitute technologies are available, there can be no guarantee that we will be able to license these technologies on commercially reasonable terms, if at all.

Defects in third party products associated with our products could impair our products' functionality and injure our reputation.

The effective implementation of our products depends upon the successful operation of third-party products in conjunction with our products. Any undetected defects in these third-party products could prevent the implementation or impair the functionality of our products, delay new product introductions or injure our reputation. In the past, while our business has not been materially harmed, product releases have been delayed as a result of errors in third-party software and we have incurred significant expenses fixing and investigating the cause of these errors.

Our customers and systems integration partners may have the ability to alter our source code and resulting inappropriate alterations could adversely affect the performance of our products, cause injury to our reputation and increase operating expenses.

Customers and systems integration partners may have access to the computer source code for certain elements of our products and may alter the source code. Alteration of our source code may lead to implementation, operation, technical support and upgrade problems for our customers. This could adversely affect the market acceptance of our products, and any necessary investigative work and repairs could cause us to incur significant expenses and delays in implementation.

If our products do not operate with the hardware and software platforms used by our customers, our customers may license competing products and our revenues will decline.

If our products fail to satisfy advancing technological requirements of our customers and potential customers, the market acceptance of these products could be reduced. We currently serve a customer base with a wide variety of constantly changing hardware, software applications and networking platforms. Customer acceptance of our products depends on many factors such as:

- Our ability to integrate our products with multiple platforms and existing or legacy systems; and,
- Our ability to anticipate and support new standards, especially Internet and enterprise Java standards.

*Our failure to successfully integrate with future acquired or merged companies and technologies could prevent us from operating efficiently.

Our business strategy includes pursuing opportunities to grow our business, both through internal growth and through merger, acquisition and technology and other asset transactions. To implement this strategy, we may be involved in merger and acquisition activity and additional technology and asset purchase transactions. Merger and acquisition transactions are motivated by many factors, including, among others, our desire to grow our business, acquire skilled personnel, obtain new technologies and expand and enhance our product offerings. Mergers and acquisitions of high-technology companies are inherently risky, and the Company cannot be certain that any acquisition will be successful and will not materially harm the Company's business, operating results or financial condition. Generally, acquisitions involve numerous risks, including the following: (i) the benefits of the acquisition (such as cost savings and synergies) not materializing as planned or not materializing within the time periods or to the extent anticipated (ii) the Company's ability to manage acquired entities' people and processes that are headquartered in separate

geographical locations from the Company’s headquarters, (iii) the possibility that the Company will pay more than the value it derives from the acquisition, (iv) difficulties in integration of the operations, technologies, content and products of the acquired companies, (v) the assumption of certain known and unknown liabilities of the acquired companies, (vi) difficulties in retaining key relationships with customers, partners and suppliers of the acquired company, (vi) the risk of diverting management’s attention from normal daily operations of the business, (vii) the Company’s ability to issue new releases of the acquired company’s products on existing or other platforms, (viii) negative impact to the Company’s financial condition and results of operations and the potential write down of impaired goodwill and intangible assets resulting from combining the acquired company’s financial condition and results of operations with its financial statements, (ix) risks of entering markets in which the Company has no or limited direct prior experience; and (x) the potential loss of key employees of the acquired company. Realization of any of these risks in connection with any technology transaction or asset purchase we have entered into, or may enter into, could have a material adverse effect on our business, operating results and financial condition.

*If we become subject to intellectual property infringement claims, including copyright or patent infringement claims, these claims could be costly and time-consuming to defend, divert management’s attention, cause product delays and have an adverse effect on our revenues and net income.

We expect that software product developers and providers of software in markets similar to our target markets will increasingly be subject to infringement claims as the number of products and competitors in our industry grows and the

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functionality of products overlap. Additionally, we are seeing copyright infringement claims being asserted by certain third party software developers. Any claims, with or without merit, could be costly and time-consuming to defend, divert our management's attention or cause product delays. If any of our products were found to infringe a third party's proprietary rights, we could be required to enter into royalty or licensing agreements to be able to sell our products. Royalty and licensing agreements, if required, may not be available on terms acceptable to us or at all.

In particular, if we are sued for patent infringement by a patent holding company, one which has acquired large numbers of patents solely for the purpose of bringing suit against alleged infringers rather than practicing the patents, it may be costly to defend such suit. We have received a letter from one such patent holding company alleging that our products may infringe one or more of their patents. We are also the subject of a suit by a person claiming that certain of our products infringe his copyrights. If any of our products were found to infringe such patentor copyrights, the patent or copyright holder could seek an injunction to enjoin our use of the infringing product. If we were not able to remove or replace the infringing portions of software with non-infringing software, and were no longer able to license some or all of our software products, such an injunction would have an extremely detrimental effect on our business. If we were required to settle such claim, it could be extremely costly. A patent or copyright infringement claim could have a material adverse effect on our business, operating results and financial condition.

The application of percentage-of-completion and completed contract accounting to our business is complex and may result in delays in the reporting of our financial results and revenue not being recognized as we expect.

Although we attempt to use standardized license agreements designed to meet current revenue recognition criteria under generally accepted accounting principles, we must often negotiate and revise terms and conditions of these standardized agreements, particularly in multi-product transactions. At the time of entering into a transaction, we assess whether any services included within the arrangement require us to perform significant implementation or customization essential to the functionality of our products. For contracts involving significant implementation or customization essential to the functionality of our products, we recognize the license and professional consulting services revenues using the percentage-of-completion method using labor hours incurred as the measure of progress towards completion. The application of the percentage-of-completion method of accounting is complex and involves judgments and estimates, which may change significantly based on customer requirements. This complexity combined with changing customer requirements could result in delays in the proper determination of our percentage-of-completion estimates and revenue not being recognized as we expect.

We have also entered into co-development projects with our customers to jointly develop new vertical applications, often over the course of a year or longer. In such cases we may only be able to recognize revenue upon delivery of the new application. The accounting treatment for these co-development projects could result in delays in the recognition of revenue. The failure to successfully complete these projects to the satisfaction of the customer could have a material adverse effect on our business, operating results and financial condition.

Changes in our revenue recognition model could result in short term declines to revenue.

Historically, a high percentage of license revenues have been accounted for on the percentage-of-completion method of accounting or recognized as revenue upon the delivery of product. If we were to enter into new types of transactions accounted for on a subscription or term basis, revenues might be recognized over a longer period of time. The impact of this change would make revenue recognition more predictable over the long term, but it might also result in a short term reduction of revenue as the new transactions took effect.

We may encounter unexpected delays in maintainingthe requisiteinternal controlsover financial reporting and we expect to incur additional expenses and diversion of management's time as a result of performing future system and process evaluation, testing and remediation required to comply with future management assessment and auditor

attestation requirements.

In connection with the Company's compliance with Section 404 under SOX for the fiscal years ended September 30, 2006 and 2005, we identified certain material weaknesses. In future periods, we will continue to document our internal controls to allow management to report on, and our independent registered public accounting firm to attest to, our internal control, over financial reporting as required by Section 404 of SOX, within the time frame required by Section 404. We may encounter unexpected delays in implementing those requirements, therefore, we cannot be certain about the timely completion of our evaluation, testing and remediation actions or the impact that these activities will have on our operations. We also expect to incur additional expenses and diversion of management's time as a result of performing the system and process evaluation, testing and remediation required to comply with management's assessment and auditor attestation requirements. If we are not able to timely comply with the requirements set forth in Section 404 in future periods, we might be subject to sanctions or investigation by the regulatory authorities. Any such action could adversely affect our business or financial results.

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Item 6. Exhibits.

The exhibits listed on the accompanying index to exhibits are filed or incorporated by reference (as stated therein) as part of this Quarterly Report on Form 10-Q.

Chordiant Software, Inc.

SIGNATURES

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

CHORDIANT SOFTWARE, INC.

By: /s/ PETER S.NORMAN
Peter S. Norman
Chief Financial Officer and
Principal Accounting Officer

Dated: February 7, 2008

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EXHIBIT INDEX

Exhibit Number	Description of Document	Incorporated by Reference Form	Date	Filed Herewith
3.1	Amended and Restated Certificate of Incorporation of Chordiant Software, Inc..	Form S-1 (No. 333-92187)	2/6/1999	
3.2	Amended and Restated Bylaws of Chordiant Software, Inc..	Form 8-K	2/2/2006	
31.1	Certification required by Rule 13a-14(a) or Rule 15d-14(a).			X
10.69	Global Framework Agreement, dated December 21, 2007, by and between Registrant and Vodafone Group Services Limited.			X
31.2	Certification required by Rule 13a-14(a) or Rule 15d-14(a).			X
32.1#	Certification required by Rule 13a-14(a) or Rule 15d-14(a) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).			X

The certification attached as Exhibit 32.1 is not deemed filed with the Securities and Exchange Commission and is not incorporated by reference into any filing of Chordiant Software, Inc., whether made before or after the date of this Form 10-K irrespective of any general incorporation language contained in such filing.