CHORDIANT SOFTWARE INC
Form 10-Q
February 09, 2006
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2005

OR

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

For the transition period from ______ to ______

Commission File Number 000-29357

Chordiant Software, Inc.

(Exact name of Registrant as specified in its Charter)

Delaware	93-1051328
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

20400 Stevens Creek Boulevard, Suite 400

Cupertino, CA 95014

(Address of Principal Executive Offices including Zip Code)

(408) 517-6100

(Registrant s Telephone Number, Including Area Code)

(Former name, former address and former fiscal year if changed since last report)

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

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

Large accelerated filer ¨ Accelerated filer **x** Non-accelerated filer ¨

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

As of January 31, 2006, there were 78,692,554 shares of the registrant s common stock outstanding.

Table of Contents

Table of Contents

CHORDIANT SOFTWARE, INC.

QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED DECEMBER 31, 2005

TABLE OF CONTENTS

Table of Contents

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

CHORDIANT SOFTWARE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

(Unaudited)

	December 31, 2005	September 30, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 41,466	$ 38,546
Restricted cash	486	1,982
Accounts receivable, net, including $144 and $263 due from related parties at December 31, 2005 and September 30, 2005, respectively	19,184	18,979
Prepaid expenses and other current assets	5,290	4,345
Total current assets	66,426	63,852
Restricted cash	365	365
Property and equipment, net	2,312	2,479
Goodwill	31,907	31,907
Intangible assets, net	4,845	5,148
Other assets	3,306	3,499
Total assets	$ 109,161	$ 107,250
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,555	$ 4,554
Accrued expenses	11,500	8,902
Deferred revenue, including related party balances of $48 and $370 at December 31, 2005 and September 30, 2005, respectively.	27,017	26,050
Current portion of capital lease obligations	217	213
Total current liabilities	42,289	39,719
Deferred revenue long-term	445	147
Restructuring costs, net of current portion	1,539	1,731
Long term portion of capital lease obligations	40	96
Total liabilities	44,313	41,693

Commitments and contingencies (Notes 5, 8 and 9)		
Stockholders equity:		
Preferred stock, $0.001 par value; 51,000 shares authorized; none issued and outstanding at December 31, 2005 and September 30, 2005		
Common stock, $0.001 par value; 300,000 shares authorized; 78,628 and 78,488 shares issued and outstanding at December 31, 2005 and September 30, 2005, respectively	79	78
Additional paid-in capital and deferred compensation	273,165	271,884
Accumulated deficit	(210,587)	(208,889)
Accumulated other comprehensive income	2,191	2,484
Total stockholders equity	64,848	65,557
Total liabilities and stockholders equity	$ 109,161	$ 107,250

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents

CHORDIANT SOFTWARE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(In thousands, except per share data)

(Unaudited)

	Three Months Ended	
	December 31, 2005	December 31, 2004
		(restated)
Revenues:		
License	$ 9,126	$ 8,842
Service, including related party items aggregating $68 for the three months ended December 31, 2005	13,432	12,835
Total revenues	22,558	21,677
Cost of revenues:		
License	443	166
Service	6,384	7,492
Amortization of intangible assets	303	131
Total cost of revenues	7,130	7,789
Gross profit	15,428	13,888
Operating expenses:		
Sales and marketing	8,104	7,209
Research and development	4,514	4,863
General and administrative	4,704	3,900
Amortization of intangible assets		24
Restructuring expense		(123)
Purchased in-process research and development		1,940
Total operating expenses	17,322	17,813
Loss from operations	(1,894)	(3,925)
Interest income, net	199	210
Other income (expense), net	118	(397)
Loss before income taxes	(1,577)	(4,112)
Provision for income taxes	121	80
Net loss	$ (1,698)	$ (4,192)
Other comprehensive income (loss):		
Foreign currency translation gain (loss)	(293)	638

Comprehensive loss	$ (1,991)	$ (3,554)
Net loss per share basic and diluted	$ (0.02)	$ (0.06)
Weighted average shares used in computing basic and diluted net loss per share	76,824	72,223

See Notes 2 and 10 to the condensed consolidated financial statements. Net loss for the three months ended December 31, 2005 included stock-based compensation expense under SFAS 123(R) of $1.1 million, which consisted of stock-based compensation expense of $0.4 million related to employee stock options and $0.7 million related to restricted stock awards. Net loss for the three months ended December 31, 2004 included a stock-based compensation net benefit of less than $0.1 million related to variable stock options and restricted stock awards. There was no stock-based compensation expense related to fixed employee stock options or employee stock purchases related to the Employee Stock Purchase Plan under SFAS 123 included in the net loss for the three months ended December 31, 2004, because the company did not adopt the recognition provisions of SFAS 123. Net loss including pro forma stock-based compensation expense (restated) as previously disclosed in the notes to the condensed consolidated financial statements for the three months ended December 31, 2004 was $5.5 million or ($0.08) per share.

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents

CHORDIANT SOFTWARE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended	
	December 31, 2005	December 31, 2004
		(restated)
Cash flows from operating activities:		
Net loss	$ (1,698)	$ (4,192)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	281	372
Purchased in-process research and development		1,940
Amortization of intangibles and capitalized software	528	155
Non-cash stock-based compensation expense (benefit)	1,056	(31)
Provision (credit) for doubtful accounts	(25)	79
Warrants issued to customers		(15)
Other non-cash charges		105
Changes in assets and liabilities:		
Accounts receivable	(376)	2,983
Prepaid expenses and other current assets	(1,255)	(637)
Other assets	(57)	121
Accounts payable	(963)	(2,094)
Accrued expenses	2,483	1,755
Deferred revenue	1,532	(1,487)
Net cash provided by (used in) operating activities	1,506	(946)
Cash flows from investing activities:		
Property and equipment purchases	(134)	(196)
Capitalized product development costs		(857)
Cash used for acquisitions, net		(7,869)
Proceeds from release of restricted cash	1,485	(3)
Net cash provided by (used for) investing activities	1,351	(8,925)
Cash flows from financing activities:		
Proceeds from exercise of stock options	528	135
Payment on capital leases	(52)	(50)
Net cash provided by financing activities	476	85
Effect of exchange rate changes	(413)	1,325
Net increase (decrease) in cash and cash equivalents	2,920	(8,461)
Cash and cash equivalents at beginning of period	38,546	55,748

Cash and cash equivalents at end of period	$ 41,466	$ 47,287

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents

CHORDIANT SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

NOTE 1 THE COMPANY

We (Chordiant Software, Inc.) are an enterprise software vendor that offers software solutions for global business-to-consumer companies that seek to improve the quality of their customer interactions and to reduce costs through increased employee productivity and process efficiencies. We concentrate on serving global customers in retail, financial services, communications and other consumer direct industries.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation

The accompanying condensed consolidated financial statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. The September 30, 2005 condensed consolidated balance sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States. However, the Company believes that the disclosures are adequate to make the information presented not misleading. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended September 30, 2005 filed with the Securities and Exchange Commission (SEC) on December 9, 2005 (2005 Form 10-K).

All adjustments, consisting of only normal recurring adjustments, which in the opinion of management, are necessary to state fairly the financial position, results of operations and cash flows for the interim periods presented have been made. The results of operations for interim periods are not necessarily indicative of the results expected for the full fiscal year or for any future period.

Restatement of quarterly results of operations

The financial information as of, and for the three months ended December 31, 2004 is labeled restated as it has been revised from the amounts previously filed in our Quarterly Report on Form 10-Q filed with the SEC on April 29, 2005. The restatement is further discussed in Note 19 of the consolidated financial statements in our 2005 Annual Report on Form 10-K.

Reclassifications

Certain reclassifications have been made to prior period balances in order to conform to the current period s presentation.

Principles of consolidation

The accompanying unaudited condensed consolidated financial statements include our accounts and those of our wholly-owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

Use of estimates

The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods.

On an on-going basis, we evaluate the estimates, including those related to our allowance for doubtful accounts, valuation of goodwill and intangible assets, valuation of deferred tax assets, certain variables associated

Table of Contents

with the valuation of stock-based compensation, restructuring costs, contingencies, vendor specific evidence 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 that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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 period to period and could result in additional 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 judgments.

Software license revenue is recognized in accordance with 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 (collectively SOP 97-2).

For arrangements with multiple elements, we recognize revenue for services and post-contract customer support based upon vendor specific objective evidence (VSOE) of fair value of the respective elements. VSOE of fair value for the services element is based upon the standard hourly rates we charge for the services when such services are sold separately. The VSOE of fair value 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 VSOE of fair value 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 require us to perform 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 revenues 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 (SOP 81-1).

The percentage-of-completion method is applied when we have the ability to make reasonable 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 services resources are required. Estimates are subject to revisions as the contract progresses to completion. We account for the changes in 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 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 revenues based upon the estimated fair value of each element.

Table of Contents

The completed contract method is applied when we are unable to obtain reasonable 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.

For product co-development arrangements relating to software products in development prior to the consummation of the individual arrangements, where the Company retains the intellectual property being developed, and intends 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 normally expensed as incurred as they are considered to be research and development costs that do not qualify for capitalization or deferral.

We recognize revenue for post-contract customer support ratably over the support periods which have historically ranged from one to three 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 the proportional performance method.

In situations in which we are obligated to provide unspecified additional software products in the future, we recognize revenue as a subscription ratably over the term of the commitment period.

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 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 collection of a fee is not probable, we defer the fee and recognize revenue at the time collection becomes probable, which is generally upon receipt of cash.

Restricted cash

At December 31, 2005 and September 30, 2005, interest bearing certificates of deposit were classified as restricted cash. These deposits serve as collateral for letters of credit securing certain lease obligations and post-contract customer support obligations. During the quarter ended December 31, 2005, $1.5 million of restricted cash that served as a security deposit on a post-contract customer support transaction was released as the underlying contract requirement expired.

Stock-Based Compensation Expense

On October 1, 2005, we adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options, restricted stock awards and employee stock purchases related to the Employee Stock Purchase Plan (ESPP) based on estimated fair values. SFAS 123(R) supersedes the Company s previous accounting using the intrinsic value method under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) for periods beginning in fiscal 2006. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107), which provided supplemental implementation guidance for SFAS 123(R). We have applied the provisions of SAB 107 in the adoption of SFAS 123(R).

We adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of October 1, 2005, the first day of the Company s fiscal year 2006. The condensed consolidated financial statements as of and for the three months ended December 31, 2005 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the condensed consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R).

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the condensed consolidated statement of operations. Prior to the adoption of SFAS 123(R), we accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under SFAS No. 123, Accounting for Stock-Based

Table of Contents

Compensation (SFAS 123). Under the intrinsic value method, when the exercise price of the Company s stock options granted to employees and directors was equal to the fair market value of the underlying stock at the date of grant, no stock-based compensation was required to be recognized under APB 25.

Stock-based compensation expense recognized during the period under SFAS 123(R) is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company s condensed consolidated statement of operations for the three months ended December 31, 2005 includes: (i) compensation expense for share-based payment awards granted prior to, but not yet vested as of September 30, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123, and (ii) compensation expense for the share-based payment awards granted subsequent to September 30, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In conjunction with the adoption of SFAS 123(R), we changed our method of expense attribution from the vested graded or straight-line method to the straight-line method. Compensation expense for all share-based payment awards granted on or prior to September 30, 2005 will continue to be recognized using the vested graded method of expense attribution while compensation expense for all share-based payment awards granted subsequent to September 30, 2005 will be recognized using the straight-line method of expense attribution. As stock-based compensation expense recognized in the condensed consolidated statement of operations for the first quarter of fiscal 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. In the pro forma disclosures required under SFAS 123 for the periods prior to fiscal 2006, we accounted for forfeitures as they occurred. See Note 10.

Upon adoption of SFAS 123(R), the Company has continued to utilize the Black-Scholes option-pricing model (Black-Scholes model) which was previously used for the Company s pro forma disclosures required under SFAS 123. For additional information, see Note 10. The Company s determination 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 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. Although the fair value of employee stock options 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.

Stock-based compensation expense recognized under SFAS 123(R) for the three months ended December 31, 2005 was $1.1 million, which includes approximately $0.4 million of incremental stock-based compensation expense for the three months ended December 31, 2005 as a result of the adoption of SFAS 123(R).

The effect of the adoption of FAS 123(R) on October 1, 2005, resulted in an increase of $0.4 million in the loss from operations, loss before income taxes and net loss compared to the continued application of APB 25 as used in the comparable prior year period. Basic and diluted net loss per share would have been $(0.03) for the three months ended December 31, 2005 if we continued to use APB 25 as in the comparable year period, compared to our reported basic and net loss per share of $(0.02) for the three months ended December 31, 2005. We have not recognized, and do not expect to recognize in the near future, any tax benefit related to employee stock-based compensation expense due to the full valuation allowance of our net deferred tax assets and our operating loss carryforwards. In addition, the adoption of FAS 123(R) did not affect our cash flow from operations or cash flow from financing activities. No stock-based compensation expense have been capitalized as part of the cost of an asset as of December 31, 2005.

Under APB 25, for the three months ended December 31, 2004, a benefit of ($0.1) million was recorded as stock-based compensation expense in the condensed consolidated statement of operations related to variable options and restricted stock awards. Previously, the compensation expense under APB 25 on variable options was re-measured at the end of each operating period until the options were exercised, forfeited or expired. Under SFAS 123(R), these options are now expensed based on the fair value approach for unvested shares as of September 30, 2005. The restricted stock awards continue to be expensed under FAS 123(R) using a vested graded or straight-line method of expense attribution consistent with the prior period.

Table of Contents

There was no stock-based compensation expense related to the ESPP recognized during the three months ended December 31, 2005 and 2004. See Note 10 for additional information.

Concentrations of credit risk

Financial instruments that potentially subject us to concentrations of credit risk consist of cash, cash equivalents, restricted cash and accounts receivable. To date, we have invested excess funds in money market accounts. We have cash and cash equivalents with various high quality institutions domestically and internationally.

Our accounts receivable are derived from sales to from customers located in North America, Europe, and elsewhere in the world. We perform ongoing credit evaluations of our customers financial condition and, generally, require no collateral from our customers. We maintain an allowance for doubtful accounts when deemed necessary. To date, bad debts have not been material and have been within management expectations.

The following table summarizes the revenues from customers that accounted for 10% or more of total revenues:

	Three Months Ended	
	December 31, 2005	December 31, 2004
Barclays	*	26%
Capital One	*	19%
ING	10%	*

* Represents less than 10% of total revenues.

At December 31, 2005, Lloyds TSB and Capital One each accounted for approximately 13% of our accounts receivable. At September 30, 2005, Capital One, Wachovia and HSBC accounted for approximately 18%, 17% and 10% of our accounts receivable, respectively.

Research and Development

Costs incurred in the research and development of new products and enhancements to existing products are charged to expense as incurred until the technological feasibility of the product or enhancement has been established. Technological feasibility of the product is determined after the completion of a detailed program design and a determination has been made that any uncertainties related to high-risk development issues have been resolved. If the process of developing the product does not include a detail program design, technological feasibility is determined only after completion of a working model. After establishing technological feasibility, additional development costs incurred through the date the product is available for general release to customers is capitalized and amortized over the estimated product life.

When technological feasibility is established through the completion of a working model the period of time between achieving technological feasibility and the general release of new products is generally short and software development costs qualifying for capitalization are insignificant. During the quarter ended September 30, 2004, technological feasibility for an acquired banking product was established through the completion of a detailed program design. Costs aggregating $2.7 million associated with this product have been capitalized and included in Other Assets as of September 30, 2005. During the quarter ended September 30, 2005, the product became available for general release and, accordingly, the costs capitalized commenced to be amortized. The capitalized costs are being amortized using the straight-line method over the remaining estimated economic life of the product which is 36 months. For the three months ended December 31, 2005, amortization expense related to this product was $0.2 million and is included in the cost of revenues for licenses.

Table of Contents

Income Taxes

We provide 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 profits, future taxable income and the fact that the market in which we compete is competitive and characterized by rapidly changing technology, we believe that there is sufficient uncertainty regarding the realization of deferred tax assets such that a full valuation allowance has been provided. At September 30, 2005, we had approximately $153.6 million and $12.5 million of net operating loss carryforwards for federal and state purposes, respectively, and net operating loss carryforwards of approximately $34.2 million in the United Kingdom.

Net loss per share

Basic and diluted net loss per share is computed by dividing the net loss for the period by the weighted average number of shares of common stock outstanding during the period excluding common stock subject to repurchase. The calculation of diluted net loss per share excludes potential common shares as their effect is anti-dilutive. Potential common shares consist of common shares issuable upon the exercise of stock options, warrants (using the treasury stock method) and common shares subject to repurchase by us.

The following table sets forth the computation of basic and diluted net loss per share for the periods indicated (in thousands, except for per share data):

	Three Months Ended	
	December 31, 2005	December 31, 2004 (restated)
Net loss available to common stockholders	$ (1,698)	$ (4,192)
Weighted average common stock outstanding	78,592	73,067
Common stock subject to repurchase	(1,768)	(844)
Denominator for basic and diluted calculation	76,824	72,223
Net loss per share basic and diluted	$ (0.02)	$ (0.06)

The following table sets forth the potential total common shares that are excluded from the calculation of diluted net loss per share as their effect is anti-dilutive as of the dates indicated (in thousands):

	December 31, 2005	December 31, 2004

Warrants outstanding	1,662	1,662
Employee stock options	8,240	10,146
Restricted stock	1,737	2,391
	11,639	14,199

Recent Accounting Pronouncements

In June, 2005, the FASB issued Statement No. 154 (SFAS 154), Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes, and Statement No. 3, Reporting Accounting Changes in Interim Financial Statements. SFAS 154 changes the requirements for the accounting for, and reporting of, a change in accounting principle. Previously, most voluntary changes in accounting principles were required to be recognized by way of a cumulative effect adjustment within net income during the period of the change. SFAS 154 requires retrospective application to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the Statement does not change the transition provisions of any existing accounting pronouncements. The Company does not believe adoption of SFAS 154 will have a material effect on our consolidated financial position, results of operations or cash flows.

In March 2005, the FASB issued Financial Interpretation No. 47 (FIN 47), Accounting for Conditional Asset Retirement Obligations an interpretation of FASB Statement No. 143. FIN 47 requires asset retirement

Table of Contents

obligations to be recorded when a legal obligation exists even though the timing and/or method of the settlement of such obligations is conditional on a future event. FIN 47 is effective for fiscal years beginning after December 15, 2005. The Company is currently evaluating the effect that the adoption of FIN 47 will have on its financial condition and results of operations but does not believe that the adoption will have a material impact.

In December 2004, the FASB issued FASB Staff Position No. FSP 109-2 (FSP 109-2), Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creations Act of 2004. FSP 109-2 provides guidance under FASB Statement No. 109 (SFAS 109), Accounting for Income Taxes, with respect to recording the potential impact of the repatriation provisions of the American Jobs Creation Act of 2004 (the Jobs Act) on enterprises income tax expense and deferred tax liability. The Jobs Act was enacted on October 22, 2004. FSP 109-2 states that an enterprise is allowed time beyond the financial reporting period of enactment to evaluate the effect of the Jobs Act on its plan for reinvestment or repatriation of foreign earnings for purposes of applying SFAS 109. FSP 109-2 is effective for fiscal years after December 15, 2005. The Company has not yet completed evaluating the impact of the repatriation provisions, however it does not anticipate the adoption will have a material impact on its consolidated financial statements. Accordingly, as provided for in FSP 109-2, we have not adjusted our tax expense or deferred tax liability to reflect the repatriation provisions of the Jobs Act.

NOTE 3 BALANCE SHEET COMPONENTS

Accounts receivable

Accounts receivable, net consists of the following (in thousands):

	December 31, 2005	**September 30, 2005**
Accounts receivable, net:		
Accounts receivable	$ 19,423	$ 19,193
Less: allowance for doubtful accounts	(239)	(214)
	$ 19,184	$ 18,979

Intangible assets

The components of intangible assets are as follows (in thousands):

	December 31, 2005	**September 30, 2005**

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets:						
Developed technologies	$ 6,904	$ (3,300)	$ 3,604	$ 6,904	$ (3,075)	$ 3,829
Customer list and tradenames	2,732	(1,491)	1,241	2,732	(1,413)	1,319
	$ 9,636	$ (4,791)	$ 4,845	$ 9,636	$ (4,488)	$ 5,148

All of our 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; customer lists and tradenames three to five years. Aggregate amortization expense for intangible assets totaled $0.3 million and $0.2 million for the three months ended December 31, 2005 and 2004, respectively. We expect amortization expense on acquired intangible assets to be $0.9 million in the remaining fiscal 2006, $1.2 million in fiscal 2007, $1.2 million in fiscal 2008, $1.2 million in fiscal 2009 and $0.3 million in fiscal 2010.

Table of Contents

Accrued expenses

Accrued expenses consist of the following (in thousands):

	December 31, 2005	September 30, 2005
Accrued expenses:		
Accrued payroll and related expenses	$ 5,743	$ 4,094
Accrued restructuring expenses, current portion (Note 5)	991	1,235
Other accrued liabilities	4,766	3,573
	$ 11,500	$ 8,902

NOTE 4 ACQUISITIONS

The operating results of KiQ Limited (KiQ) have been included in the condensed consolidated financial statements since the acquisition date of December 21, 2004. The following unaudited pro forma condensed consolidated financial information reflects the results of operations for the three months ended December 31, 2004 as if the acquisition of KiQ had occurred on October 1, 2004, after giving effect to purchase accounting adjustments. The purchased in-process research and development expense of $1.9 million has not been included in the pro forma results of operations for the three months ended December 31, 2004 because it is considered a non-recurring charge. These pro forma results have been prepared for comparative purposes only, do not purport to be indicative of what operating results would have been had the acquisition actually taken place at the beginning of the period, and may not be indicative of future operating results (in thousands, except per share data):

	Three Months Ended December 31, 2004 (restated)
Pro forma adjusted total revenue	$ 22,571
Pro forma adjusted net loss	$ (2,716)
Pro forma adjusted net loss per share basic and diluted	$ (0.04)
Pro forma weighted average shares basic and diluted	76,575

NOTE 5 RESTRUCTURING

Restructuring Costs

Through September 30, 2005, the Company has approved certain restructuring plans to, among other things, reduce its workforce and consolidate facilities. Restructuring and asset impairment charges have been taken to align our cost structure with changing market conditions and to create a more efficient organization. Our restructuring charges have been comprised primarily of: (i) severance and benefits termination costs related to the reduction of our workforce; and (ii) lease termination costs and costs associated with permanently vacating certain facilities. We account for each of these costs in accordance with SFAS No. 146 (SFAS 146), Accounting for Costs Associated with Exit or Disposal Activities.

Retroactive application of SFAS 146 to periods prior to January 1, 2003 was prohibited and, accordingly, the accrual relating to facilities continues to be accounted for in accordance with the preexisting guidance. The accrual for facilities does not reflect any adjustments relating to the estimated net present value of cash flows associated with the facilities.

For each of the periods presented herein, restructuring charges 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 space under lease, net of estimated sublease income and planned company occupancy.

12

Table of Contents

As of December 31, 2005, the total restructuring accrual of $2.5 million consisted of the following (in thousands):

	Current	Non-Current	Total
Severance and Termination	$ 101	$	$ 101
Excess Facilities	890	1,539	2,429
Total	$ 991	$ 1,539	$ 2,530

The Company expects the remaining severance and termination accrual will be substantially paid by June 30, 2006.

Included in the facilities reserve is a note payable associated with the buyout of an office lease located in New York City. The amount of the note payable is $0.2 million and it is payable through quarterly installments through June 2011. We expect to pay the excess facilities amounts related to restructured or abandoned leased space as follows (in thousands):

Fiscal Year Ended September 30,	Total future minimum payments
2006 (remaining nine months)	$ 402
2007	470
2008	470
2009	470
2010	470
2011	147
Total minimum facility payments	$ 2,429

Fiscal year 2005 Restructuring

In May 2005, the Company announced that it had appointed a task force to improve profitability and control expenses (the Profitability Task Force). The goal of the Profitability Task Force is to create 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 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. As a result of the work of the Profitability Task Force, management undertook an approximate 10% reduction in the Company s workforce, and in July 2005 affected employees were notified. In connection with this action, 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.

The following table summarizes the activity related to the fiscal year 2005 restructuring (in thousands):

	Severance and Benefits
Reserve balance at September 30, 2005	$ 469
Non-cash	(1)
Cash paid	(367)
Reserve balance at December 31, 2005	$ 101

Prior to Fiscal Year 2005 Restructurings

During fiscal year 2003, based upon our continued evaluation of economic conditions in the information technology industry and our expectations regarding revenue levels, we restructured several areas of the Company to reduce expenses and improve our revenue per employee. This restructuring program included a worldwide workforce reduction, and consolidation of excess facilities and certain business functions. We believe that these reductions and realignments have resulted and will continue to result in a more responsive management structure. As part of these restructuring programs, we recorded a total workforce reduction expense relating to severance

Table of Contents

and benefits of approximately $2.0 million for year ended December 31, 2003. In addition to these costs, we accrued lease costs related to excess facilities of $0.2 million and $2.8 million during the year ended December 31, 2003, pertaining to the consolidation of excess facilities relating to lease terminations and non-cancelable lease costs. This expense is net of estimated sub-lease income based on current comparable rates for leases in the respective markets. If facilities rental rates decrease in these markets or if it takes longer than expected to sublease these facilities, the maximum amount by which the actual loss could exceed the original estimate is approximately $0.9 million.

The following table summarizes the activity related to the restructuring for the three months ended December 31, 2005 (in thousands):

	Facilities
Reserve balance at September 30, 2005	$ 2,497
Cash paid	(68)
Reserve balance at December 31, 2005	$ 2,429

Ness Technologies

As part of the fiscal year 2003 restructuring, 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 will provide 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 has an initial term of three years and may be extended for additional one year terms at our discretion. Under the terms of the agreement, we pay for services rendered on a monthly fee basis, including the requirement to reimburse Ness for approved out-of-pocket expenses. We have also guaranteed certain equipment lease obligations of Ness (See Notes 7 and 8). The agreement may be terminated for convenience by the Company, subject to the payment of a termination fee. At December 31, 2005 the estimated termination fee would be $0.7 million if exercised. The maximum termination fee was initially equal to three months of certain fees, declining to zero after 30 months. On June 16, 2004, the Company expanded its agreement with Ness whereby Ness consultants are providing staffing for certain consulting projects. This amended agreement is cancelable at the Company s option, subject to the payment of a cancellation fee of approximately $0.1 million. On March 15, 2005, the Company further expanded its agreement with Ness whereby Ness is providing certain additional technical and consulting services. The additional agreement can be cancelled at the option of the Company. Remaining minimum purchase commitments under this agreement were approximately $0.1 million at December 31, 2005.

NOTE 6 RELATED PARTY TRANSACTIONS

In August 2005, the Company entered into a service provider agreement with Infogain. Samuel T. Spadafora, one of our directors and executive officers, is also a director of Infogain. Pursuant to the service provider agreement, revenue from Infogain was less than $0.1 million for three months ended December 31, 2005. Accounts receivable as of December 31, 2005 and September 30, 2005 were less than $0.1 million.

In January 2005, Charles E. Hoffman became a director of the Company. Mr. Hoffman is the President and Chief Executive Officer of Covad Communications Group, Inc. (Covad), a customer of ours. Pursuant to software license and services agreements, revenue from Covad was less than $0.1 million for the three months ended December 31, 2005. Accounts receivable as of December 31, 2005 and September 30, 2005 were approximately $0.1 million and zero, respectively.

Table of Contents

NOTE 7 BORROWINGS

Revolving line of credit

Our line of credit with Comerica Bank, effective from March 28, 2003 and extended to March 25, 2006, was amended in September 2005 and is comprised of a $5.0 million accounts receivable line. The terms of the line of credit require us to maintain (i) at least a $5.0 million cash balance in Comerica Bank accounts, (ii) a minimum quick ratio of 2.00 to 1.00, (iii) a tangible net worth of at least $20.0 million plus 60% of the proceeds of any equity offerings 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. As of December 31, 2005, the Company was in compliance with the respective debt covenants.

The accounts receivable line of credit contains a provision for a sub-limit of up to $2.0 million for issuances of standby commercial letters of credit. As of December 31, 2005 and September 30, 2005, we had utilized $1.4 million of the $2.0 million standby commercial letter of credit limit of which $0.9 million serves as collateral for computer equipment leases for our outsourcing partner in India (see Notes 5 and 8). The accounts receivable line of credit also contains a provision for a sub-limit of up to $2.0 million for issuance of foreign exchange forward contracts. As of December 31, 2005, we had not entered into any foreign exchange forward contracts. Pursuant to the amendment in September 2005, we are required to secure our standby commercial letters of credit and foreign exchange forward contracts as of March 25, 2006. If these have not been secured to Comerica Bank s satisfaction, our 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 accounts receivable line of credit bear interest at the lending bank s prime rate plus 0.5%. Advances are available on a non-formula basis up to $2.0 million (non-formula portion); however, if advances exceed $2.0 million, then subsequent advances cannot exceed 80% of eligible accounts receivable balances, and the bank would hold a security interest in those accounts receivable. Except for the standby commercial letters of credit, as of December 31, 2005, there was no outstanding balance on our accounts receivable line of credit.

NOTE 8 COMMITMENTS AND CONTINGENCIES

We lease our facilities and some equipment under non-cancelable operating leases that expire on various dates through 2011. Rent expense is recognized on a straight line basis over the lease term. In addition, the Company has entered into non-cancelable capital leases having expiration dates through 2007. Future minimum lease payments as of December 31, 2005 are as follows (in thousands):

	Capital Leases	Operating Leases	Operating Sublease Income	Net Operating Leases
Fiscal Year Ended September 30:				
2006 (remaining nine months)	$ 171	$ 2,560	$ (214)	$ 2,346
2007	97	3,308		3,308
2008		2,985		2,985
2009		2,034		2,034
2010		1,060		1,060
Thereafter		224		224

Total minimum payments	268	$ 12,171	$ (214)	$ 11,957
Less: amount representing interest	(11)			
Present value of minimum lease payments	257			
Less: current portion of capital lease obligations	(217)			
Capital lease obligations, non-current	$ 40			

Operating lease payments in the table above include approximately $3.3 million, net of sublease income receivable under existing subleases, for operating lease commitments for facilities that are included in restructuring charges. See Note 5, Restructuring, for a further discussion.