

EGAIN COMMUNICATIONS CORP

Form 10-Q

November 14, 2007

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2007

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 No. 0-30260

**eGAIN COMMUNICATIONS CORPORATION**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction)

**77-0466366**  
(I.R.S. Employer Identification No.)

of incorporation or organization)

**345 E. Middlefield, Mountain View, CA**

(Address of principal executive offices)

**94043**

(Zip Code)

**(650) 230-7500**

(Registrant's telephone number, including area code)

N/A

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

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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  No

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

Large accelerated filer  Accelerated filer  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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class                          | Outstanding at September 30, 2007 |
|--------------------------------|-----------------------------------|
| Common Stock \$0.001 par value | 15,323,376                        |

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**eGAIN COMMUNICATIONS CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands)

|   | September 30,<br>2007<br>(unaudited) | June 30,<br>2007 |
|---|--------------------------------------|------------------|
| <b>ASSETS</b>                                       |                                      |                  |
| Current assets:                                     |                                      |                  |
| Cash and cash equivalents                           | \$ 3,552                             | \$ 6,195         |
| Restricted cash                                     | 13                                   | 13               |
| Accounts receivable, net                            | 2,973                                | 1,790            |
| Prepaid and other current assets                    | 607                                  | 662              |
| <b>Total current assets</b>                         | <b>7,145</b>                         | <b>8,660</b>     |
| Property and equipment, net                         | 1,326                                | 1,336            |
| Goodwill  | 4,880                                | 4,880            |
| Other assets  | 488                                  | 486              |
|   | <b>\$ 13,839</b>                     | <b>\$ 15,362</b> |
| <b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>         |                                      |                  |
| Current liabilities:                                |                                      |                  |
| Accounts payable                                    | \$ 1,781                             | \$ 1,557         |
| Accrued compensation                                | 1,627                                | 1,884            |
| Accrued liabilities                                 | 1,715                                | 1,496            |
| Deferred revenue                                    | 6,111                                | 5,541            |
| Current portion of bank borrowings                  | 2,149                                | 2,293            |
| <b>Total current liabilities</b>                    | <b>13,383</b>                        | <b>12,771</b>    |
| Related party notes payable, net of current portion | 12,045                               | 11,653           |
| Bank borrowing, net of current portion              |                                      | 167              |
| Other long term liabilities                         | 177                                  | 185              |
| <b>Total liabilities</b>                            | <b>25,605</b>                        | <b>24,776</b>    |
| Commitments (Note 10)                               |                                      |                  |
| Stockholders' deficit:                              |                                      |                  |
| Common stock  | 15                                   | 15               |
| Additional paid-in capital                          | 316,256                              | 316,202          |
| Notes receivable from stockholders                  | (78)                                 | (77)             |
| Accumulated other comprehensive loss                | (443)                                | (438)            |
| Accumulated deficit                                 | (327,516)                            | (325,116)        |
| <b>Total stockholders' deficit</b>                  | <b>(11,766)</b>                      | <b>(9,414)</b>   |
|   | <b>\$ 13,839</b>                     | <b>\$ 15,362</b> |

**See accompanying notes**

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**eGAIN COMMUNICATIONS CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share data)

(unaudited)

|   | <b>Three Months</b>        |             |             |
|---|----------------------------|-------------|-------------|
|   | <b>Ended September 30,</b> | <b>2007</b> | <b>2006</b> |
| <b>Revenue:</b>   |                            |             |             |
| License   | \$ 1,423                   | \$ 1,635    |             |
| Support and services  | 5,048                      | 4,368       |             |
| <br>  |                            |             |             |
| Total revenue   | 6,471                      | 6,003       |             |
| Cost of license   | 20                         | 41          |             |
| Cost of support and services  | 2,675                      | 1,941       |             |
| <br>  |                            |             |             |
| Gross profit  | 3,776                      | 4,021       |             |
| <br><b>Operating costs and expenses:</b>  |                            |             |             |
| Research and development  | 1,144                      | 1,025       |             |
| Sales and marketing   | 3,141                      | 3,287       |             |
| General and administrative  | 1,423                      | 940         |             |
| <br>  |                            |             |             |
| Total operating costs and expenses  | 5,708                      | 5,252       |             |
| <br>  |                            |             |             |
| Loss from operations  | (1,932)                    | (1,231)     |             |
| Interest expense, net   | (404)                      | (270)       |             |
| Other income, net   | 42                         | 27          |             |
| <br>  |                            |             |             |
| Loss before income taxes  | (2,294)                    | (1,474)     |             |
| Provision for income taxes  | (106)                      | (15)        |             |
| <br>  |                            |             |             |
| Net loss  | \$ (2,400)                 | \$ (1,489)  |             |
| <br><b>Per Share information:</b>   |                            |             |             |
| Basic/diluted net loss per common share   | \$ (0.16)                  | \$ (0.10)   |             |
| <br>  |                            |             |             |
| Weighted average shares used in computing basic/diluted net loss per common share | 15,323                     | 15,314      |             |

See accompanying notes

**Table of Contents****eGAIN COMMUNICATIONS CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

|   | <b>Three Months</b>        |                 |
|---|----------------------------|-----------------|
|   | <b>Ended September 30,</b> | <b>2006</b>     |
|   | <b>2007</b>                | <b>2006</b>     |
| <b>Cash flows from operating activities:</b>                            |                            |                 |
| Net Loss  | \$ (2,400)                 | \$ (1,489)      |
| Adjustments to reconcile loss to net cash used in operating activities: |                            |                 |
| Depreciation  | 191                        | 140             |
| Stock-based compensation  | 53                         | 75              |
| Provisions for doubtful accounts and sales returns                      | 162                        | 307             |
| Accrued interest and amortization of discount on related party notes    | 392                        | 283             |
| Changes in operating assets and liabilities:                            |                            |                 |
| Accounts receivable   | (1,336)                    | (1,393)         |
| Prepaid and other current assets  | 240                        | 2               |
| Other assets  | (173)                      | 4               |
| Accounts payable  | 218                        | 56              |
| Accrued compensation  | (276)                      | 320             |
| Accrued liabilities   | 200                        | 589             |
| Deferred revenue  | 538                        | (435)           |
| Other long term liabilities   | (8)                        | (8)             |
| <b>Net cash used in by operating activities</b>                         | <b>(2,199)</b>             | <b>(1,549)</b>  |
| <b>Cash flows from investing activities:</b>                            |                            |                 |
| Purchases of property and equipment                                     | (165)                      | (83)            |
| <b>Net cash used in investing activities</b>                            | <b>(165)</b>               | <b>(83)</b>     |
| <b>Cash flows from financing activities:</b>                            |                            |                 |
| Payments on borrowings  | (2,440)                    | (1,553)         |
| Proceeds from borrowings  | 2,130                      | 1,500           |
| Net proceeds from issuance of common stock                              | 1                          | 1               |
| <b>Net cash (used in) provided by financing activities</b>              | <b>(309)</b>               | <b>(52)</b>     |
| Effect of change in exchange rates on cash and cash equivalents         | 30                         | (58)            |
| <b>Net decrease in cash and cash equivalents</b>                        | <b>(2,643)</b>             | <b>(1,742)</b>  |
| Cash and cash equivalents at beginning of period                        | 6,195                      | 6,916           |
| <b>Cash and cash equivalents at end of period</b>                       | <b>\$ 3,552</b>            | <b>\$ 5,174</b> |
| <b>Supplemental cash flow disclosures:</b>                              |                            |                 |
| Cash paid for interest  | \$ 39                      | \$ 22           |
| Cash paid for taxes   | 2                          | 15              |

**See accompanying notes**



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**eGAIN COMMUNICATIONS CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1. Organization, Nature of Business, Basis of Presentation and Liquidity**

We are a leading provider of customer service and contact center software, used by global enterprises and fast-growing businesses. Trusted by prominent enterprises and growing mid-sized companies worldwide, eGain's award winning software has been helping organizations achieve and sustain customer service excellence for more than a decade.

We have prepared the condensed consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission and included the accounts of our wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

Certain information and footnote disclosures, normally included in financial statements prepared in accordance with generally accepted accounting principles, have been condensed or omitted pursuant to such rules and regulations. In our opinion, the unaudited condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of our financial position, results of operations and cash flows for the periods presented. These financial statements and notes should be read in conjunction with our audited consolidated financial statements and notes thereto for the fiscal year ended June 30, 2007, included in our Annual Report on Form 10-K. The condensed consolidated balance sheet at June 30, 2007 has been derived from audited financial statements as of that date but does not include all the information and footnotes required by generally accepted accounting principles for complete financial statements. The results of our operations for the interim periods presented are not necessarily indicative of results that may be expected for any other interim period or for the full fiscal year ending June 30, 2008.

The accompanying consolidated financial statements have been prepared assuming that we will continue as a going concern. At September 30, 2007, we had \$3.6 million of cash and cash equivalents on hand, a stockholder's deficit of \$11.8 million and an accumulated deficit of \$328.0 million. Our operating history shows our inability to consistently generate profits from operations. We anticipate that our current cash and cash equivalents will be sufficient to satisfy our working capital and capital requirements for at least through September 30, 2008. However, if our future operations do not generate sufficient revenues and operating profits to cover expenses, and if we are required to raise additional financing, we cannot assure that additional financing will be available on favorable terms, when needed, if at all. If we are unable to obtain any necessary additional financing, we may be required to further reduce the scope of our planned sales and marketing and product development efforts, which could materially and adversely affect our business, financial condition and operating results.

**Note 2. Software Revenue Recognition**

*Revenue Recognition*

We derive revenues from two sources: license fees, and support and services. Support and services includes hosting, software maintenance and support and professional services. Maintenance and support consists of technical support and software upgrades and enhancements. Professional services primarily consist of consulting and implementation services and training. Significant management judgments and estimates are made and used to determine the revenue recognized in any accounting period. Material differences may result in the amount and timing of our revenue for any period if different conditions were to prevail.

We apply the provisions of Statement of Position ( SOP ) No. 97-2, *Software Revenue Recognition*, ( SOP 97-2 ) as amended by SOP No. 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*, ( SOP 98-9 ) to all transactions involving the licensing of software products. In the event of a multiple element arrangement for a license transaction we evaluate the transaction as if each element represents a separate unit of accounting taking into account all factors following the guidelines set forth in SOP 97-2, or for a hosting transaction, Emerging Issues Task Force Issue ( EITF ) No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*, ( EITF 00-21 ). For professional services, where the services are not essential to the functionality, the services revenue are recognized in accordance with SOP 97-2. If the services are essential to the functionality, the services revenues are recognized in accordance with the provisions of SOP No. 81-1, *Accounting for Performance of Construction Type and Certain Production Type Contracts*, ( SOP 81-1 ).

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When licenses are sold together with system implementation and consulting services, license fees are recognized upon delivery, generally the date of electronic transmission or shipment, provided that (i) payment of the license fees is not dependent upon the performance of the consulting and implementation services, (ii) the services are available from other vendors, (iii) the services qualify for separate accounting as we have sufficient experience in providing such services, have the ability to estimate cost of providing such services, and we have vendor specific objective evidence of pricing, and (iv) the services are not essential to the functionality of the software.

We use signed software license and services agreements and order forms as evidence of an arrangement for sales of software, hosting, maintenance and support. We use signed engagement letters to evidence an arrangement for professional services.

### *License Revenue*

We recognize license revenue when persuasive evidence of an arrangement exists, the product has been delivered, no significant obligations remain, the fee is fixed or determinable, and collection of the resulting receivable is probable. In software arrangements that include rights to multiple software products and/or services, and have vendor specific objective evidence on all of the undelivered elements, we use the residual method to recognize revenue. Under the residual method, revenue is allocated to the undelivered elements based on vendor specific objective evidence of the fair value of such undelivered elements. The residual amount of revenue is then allocated to the delivered elements and recognized as revenue assuming all other criteria for revenue recognition have been met. Such undelivered elements in these arrangements typically consist of software maintenance and support, implementation and consulting services and in some cases hosting services.

Software is delivered to customers electronically or on a CD-ROM, and license files are delivered electronically. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction. We have standard payment terms included in our contracts. We assess collectibility based on a number of factors, including the customer's past payment history and its current creditworthiness. If we determine that collection of a fee is not reasonably assured, we defer the revenue and recognize it at the time collection becomes reasonably assured, which is generally upon receipt of cash payment. If an acceptance period is required, revenue is recognized upon the earlier of customer acceptance or the expiration of the acceptance period.

We periodically sell to resellers. License sales to resellers as a percentage of total revenue was approximately 7% for the quarter ended September 30, 2007 compared to 5% for the comparable year ago quarter. Revenue from sales to resellers is generally recognized upon delivery to the reseller but depends on the facts and circumstances of the transaction, such as our understanding of the reseller's plans to sell the software, if there are any return provisions, price protection or other allowances, the reseller's financial status and our past experience with the particular reseller. Historically sales to resellers have not included any return provisions, price protections, other allowances, or extended payment terms.

### *Professional Services Revenue*

Included in support and services revenues are revenues derived from system implementation, consulting and training. For license transactions, the majority of our consulting and implementation services and accompanying agreements qualify for separate accounting. We use vendor specific objective evidence of fair value for the services and maintenance to account for the arrangement using the residual method, regardless of any separate prices stated within the contract for each element. Our consulting and implementation service contracts are bid either on a fixed-fee basis or on a time-and-materials basis. Substantially all of our contracts are on a time-and-materials basis. For time-and-materials contracts, where the services are not essential to the functionality of the software, we recognize revenue as services are performed. If the services are essential to functionality, then both the product license revenue and the service revenues are recognized under the percentage of completion method. For a fixed-fee contract where services are not essential to the functionality, we recognize revenue based upon the costs and efforts to complete the services in accordance with the proportional performance method provided we are able to estimate such cost and efforts. If the fixed fee services are essential to the functionality, we recognize the revenue using contract accounting in accordance with SOP 81-1.

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In August 2006, we entered into an OEM agreement with Cisco Systems. Under this agreement we will supply unified communications technology for use in certain Cisco products. Pursuant to the agreement, there are certain minimum royalty payments due to us from Cisco based upon our successful delivery of certain milestones that are projected over the first eighteen months of the agreement. The first major milestone was delivered and accepted in December 2006. The second major milestone was delivered and accepted in August 2007. This OEM agreement with Cisco includes multiple elements, including significant product customizations that are subject to Cisco's acceptance. We have determined that this arrangement should be accounted for under the contract accounting method in accordance with paragraph 65 of SOP 97-2. In addition, we have determined that no loss will be incurred in the arrangement, however, at present the lowest probable level of profit cannot be determined as we are still in the development stage of the agreement, and therefore, a zero estimate of profit is used in calculating revenue. Revenue from this arrangement as a percentage of total revenue was approximately 2% for the three months ended September 30, 2007, and is all related to professional services revenue.

For hosting consulting and implementation services that do not qualify for separate accounting, we recognize the services revenue ratably over the estimated life of the customer hosting relationship.

Training revenue is recognized when training is provided, or in the case of hosting, when the customer also has access to the hosting services, if such training services meet the separable criteria.

### *Hosting Services Revenue*

Included in support services revenues are revenues derived from our hosted service offerings. We recognize hosting services revenue ratably over the period of the applicable agreement as services are provided. Hosting agreements are typically for a period of one or two years and automatically renew unless either party cancels the agreement. The majority of the hosting services customers purchase a combination of our hosting service and professional services. In some cases the customer may also acquire a license for the software.

We evaluate whether each of the elements in these arrangements represents a separate unit of accounting, as defined by EITF 00-21, using all applicable facts and circumstances, including whether (i) we sell or could readily sell the element unaccompanied by the other elements, (ii) the element has stand-alone value to the customer, (iii) there is objective reliable evidence of the fair value of the undelivered item, and (iv) there is a general right of return. We consider the applicability of EITF No. 00-03, *Application of SOP 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware*, ( EITF 00-03 ) on a contract-by-contract basis. In hosted term-based agreements, where the customer does not have the contractual right to take possession of the software, the revenue is recognized on a monthly basis over the term of the contract. Amounts that are billable are invoiced and recorded in accounts receivable and in deferred revenue or revenue, depending on whether the revenue recognition criteria have been met. For professional services that we determine do not have stand-alone value to the customer, we recognize the services revenue ratably over the longer of the remaining contractual period or the remaining estimated life of the customer hosting relationship, once hosting has gone live. We currently estimate life of the customer hosting relationship to be 20 months, based on the average life of all hosting customer relationships.

If we determine that the customer has the contractual right to take possession of our software at any time during the hosting period without significant penalty, and can feasibly run the software on its own hardware or enter into another arrangement with a third party to host the software, a software element covered by SOP 97-2 exists. When a software element exists in a hosting services arrangement, we recognize the license, professional services and hosting services revenues pursuant to SOP 97-2. We have established vendor specific objective evidence for the hosting and support elements of perpetual license sales, based on the prices charged when sold separately and substantive renewal terms. Accordingly, revenue for the perpetual software license element is determined using the residual method and is recognized upon delivery. Revenue for the hosting and support elements is recognized ratably over the contractual time period. Professional services are recognized as described above under *Professional Services Revenue* . If evidence of fair value cannot be established for the undelivered elements of an agreement, the entire amount of revenue from the arrangement is recognized ratably over the period that these elements are delivered.

**Table of Contents***Maintenance and Support Revenue*

Included in support services revenues are revenues derived from maintenance and support. Maintenance and support revenue is recognized ratably over the term of the maintenance contract, which is typically one year. Maintenance and support is renewable by the customer on an annual basis. Rates for maintenance and support, including subsequent renewal rates, are typically established based upon a specified percentage of net license fees as set forth in the arrangement.

**Note 3. Stock-Based Compensation**

Under SFAS 123R, the stock compensation expense in our unaudited condensed consolidated statement of operations for the three months ended September 30, 2007 and 2006 was \$53,000 and \$75,000, respectively.

Below is a summary of stock-based compensation included in the costs and expenses (unaudited, in thousands):

|   | <b>Three months ended<br/>September 30,</b> |              |
|---|---|--------------|
|   | <b>2007</b>                                 | <b>2006</b>  |
| Cost of support and services                  | \$ 11                                       | \$ 14        |
| Research and development                      | 11  | 11           |
| Sales and marketing                           | 22  | 31           |
| General and administrative                    | 9   | 19           |
| <b>Total stock-based compensation expense</b> | <b>\$ 53</b>                                | <b>\$ 75</b> |

We utilized the Black-Scholes valuation model for estimating the fair value of the stock compensation granted after the adoption of SFAS 123R. All shares of our common stock issued pursuant to the our stock option plans are only issued out of an authorized reserve of shares of common stock which were previously registered on Form S-8. Options granted during the three months ended September 30, 2007 and 2006, were 135,850 and 73,500, respectively. The weighted-average fair value of the options granted under our stock option plans for the three months ended September 30, 2007 and 2006 was \$0.86 and \$1.04, respectively, using the following assumptions:

|                                 | <b>Three months ended<br/>September 30,</b> |             |
|---------------------------------|---|-------------|
|                                 | <b>2007</b>                                 | <b>2006</b> |
| Dividend yield                  |   |             |
| Expected volatility             | 92%   | 92%         |
| Average risk-free interest rate | 4.55%                                       | 4.85%       |
| Expected life (in years)        | 6.25  | 6.25        |

The dividend yield of zero is based on the fact that we have never paid cash dividends and have no present intention to pay cash dividends. We determined the appropriate measure of expected volatility by reviewing historic volatility in the share price of our common stock. The risk-free interest rate is derived from the average U.S. Treasury Strips rate with maturities approximating the expected lives of the awards during the period, which approximate the rate in effect at the time of the grant.

In developing our estimate of expected life, we determined that our historical share option exercise experience does not provide a reasonable basis upon which to estimate expected life. In addition, estimating life based on the expected terms of options granted by other, similar companies with similarly structured awards was considered but data was not readily available to arrive at reliable estimates. We therefore used the technique commonly referred to as the simplified method. In Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment*, (SAB 107) the SEC staff described a temporary simplified method to develop the estimate of the expected life of a plain vanilla employee stock option. Under this approach, the expected life would be presumed to be the mid-point between the vesting date and the end of the contractual term. The shortcut approach is not permitted for options granted, modified or settled after December 31, 2007.

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Based on our historical experience of option pre-vesting cancellations, we have assumed an annualized 14% forfeiture rate for our options. Under the true-up provisions of SFAS 123R, we will record additional expense if the actual forfeiture rate is lower than we estimated, and will record a recovery of prior expense if the actual forfeiture is higher than we estimated.

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Total compensation cost of all options granted but not yet vested as of September 30, 2007 was \$223,000, which is expected to be recognized over the weighted average period of 2.97 years. Options exercised for the three months ended September 30, 2007 and 2006 were 1,268 and 1,026, respectively. There is no tax benefit related to these options exercised.

**Note 4. Net Loss Per Common Share**

Basic net loss per common share is computed using the weighted-average number of shares of common stock outstanding.

The following table sets forth a reconciliation of shares used in calculating basic and diluted earnings per share (unaudited in thousands, except per share data):

|  | Three months ended<br>September 30, |            |
|--|-------------------------------------|------------|
|  | 2007                                | 2006       |
| Net loss applicable to common stockholders   | \$ (2,400)                          | \$ (1,489) |
| Weighted-average common shares used in computing basic and diluted net loss per common share | 15,323                              | 15,314     |
| Basic and Diluted net loss per common share  | \$ (0.16)                           | \$ (0.10)  |

Outstanding options and warrants to purchase 2,501,466 and 2,381,595 shares of common stock at September 30, 2007 and 2006, respectively, were not included in the computation of diluted net loss per common share for the periods presented as a result of their anti-dilutive effect. Such securities could have a dilutive effect in future periods.

**Note 5. Comprehensive Loss**

eGain reports comprehensive loss and its components in accordance with SFAS No. 130, *Reporting Comprehensive Income*, ( SFAS 130 ). Under SFAS 130, comprehensive income includes all changes in equity during a period except those resulting from investments by or distributions to owners. The comprehensive loss was \$2.4 million for the quarter ended September 30, 2007 and the comprehensive loss was \$1.5 million for the quarter ended September 30, 2006. Accumulated other comprehensive loss presented in the accompanying consolidated balance sheets at September 30, 2007 and September 30, 2006 consists solely of accumulated foreign currency translation adjustments.

The table below summarizes the information in thousands (unaudited):

|  | Three months ended<br>September 30, |            |
|--|-------------------------------------|------------|
|  | 2007                                | 2006       |
| Net loss                                 | \$ (2,400)                          | \$ (1,489) |
| Foreign currency translation adjustments | (5)                                 | 19         |
| Comprehensive loss                       | \$ (2,405)                          | \$ (1,470) |

**Note 6. Segment Information**

We operate in one segment, the development, license, implementation and support of our customer service infrastructure software solutions. Operating segments are identified as components of an enterprise for which discrete financial information is available and regularly reviewed by the company's chief operating decision-makers in order to make decisions about resources to be allocated to the segment and assess its performance. Our chief

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operating decision-makers, as defined under SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, ( SFAS 131 ) are our executive management team. Our chief operating decision-makers review financial information presented on a consolidated basis, for purposes of making operating decisions and assessing financial performance.

Information relating to our geographic areas is as follows (unaudited, in thousands):

|                                 | <b>Three Months Ended<br/>September 30,</b> |                   |
|---------------------------------|---|-------------------|
|                                 | <b>2007</b>                                 | <b>2006</b>       |
| <b>Total Revenue:</b>           |   |                   |
| North America                   | \$ 4,331                                    | \$ 3,516          |
| Europe                          | 2,080                                       | 2,389             |
| Asia Pacific                    | 60  | 98                |
|                                 | <b>\$ 6,471</b>                             | <b>\$ 6,003</b>   |
| <b>Operating Income (Loss):</b> |   |                   |
| North America                   | \$ (72)                                     | \$ (458)          |
| Europe                          | (1,026)                                     | (179)             |
| Asia Pacific*                   | (834)                                       | (594)             |
|                                 | <b>\$ (1,932)</b>                           | <b>\$ (1,231)</b> |

\* Includes costs associated with corporate support.

In addition, identifiable tangible assets corresponding to our geographic areas are as follows (unaudited, in thousands):

|               | <b>September 30,</b> |                  |
|---------------|----------------------|------------------|
|               | <b>2007</b>          | <b>2006</b>      |
| North America | \$ 5,424             | \$ 5,831         |
| Europe        | 2,462                | 4,206            |
| Asia Pacific  | 1,073                | 666              |
|               | <b>\$ 8,959</b>      | <b>\$ 10,703</b> |

The following table provides the revenue for the three months ended September 30, 2007 and 2006 (unaudited, in thousands):

|                          | <b>Three Months Ended<br/>September 30,</b> |                 |
|--------------------------|---|-----------------|
|                          | <b>2007</b>                                 | <b>2006</b>     |
| <b>Revenue :</b>         |   |                 |
| License                  | \$ 1,423                                    | \$ 1,635        |
| Hosting services         | 1,278                                       | 1,020           |
| Maint & support services | 2,179                                       | 2,170           |
| Professional services    | 1,591                                       | 1,178           |
|                          | <b>\$ 6,471</b>                             | <b>\$ 6,003</b> |

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For the three months ended September 30, 2007, there was no customer that accounted for more than 10% of total revenue. There was one customer Caremark Rx, Inc. that accounted for 13% of total revenue in the comparable year-ago quarter.



**Table of Contents****Note 7. Related Party Notes Payable***Ashutosh Roy Notes*

During fiscal year 2003, we entered into a note and warrant purchase agreement with Ashutosh Roy, our Chief Executive Officer, pursuant to which Mr. Roy made loans to us evidenced by subordinated secured promissory notes and received warrants to purchase shares of our common stock in connection with each of such loans. The five year subordinated secured promissory note bears interest at an effective annual rate of 12% due and payable upon the term of such note. We have the option to prepay each note at any time subject to the prepayment penalties set forth in such note. On December 31, 2002, Mr. Roy loaned us \$2.0 million under the agreement and received warrants that allow him to purchase up to 236,742 shares at an exercise price equal to \$2.11 per share. These warrants expired in December 2005. In connection with this loan, we recorded \$1.83 million in related party notes payable and \$173,000 of discount on the note related to the relative value of the warrants issued in the transaction that will be amortized to interest expense over the five year life of the note. The fair value of these warrants was determined using the Black-Scholes valuation method with the following assumptions: an expected life of 3 years, an expected stock price volatility of 75%, a risk free interest rate of 2%, and a dividend yield of 0%.

On October, 31, 2003, we entered into an amendment to the 2002 note and warrant purchase agreement with Mr. Roy, pursuant to which he loaned to us an additional \$2.0 million and received additional warrants to purchase up to 128,766 shares at \$3.88 per share. In connection with this additional loan we recorded \$1.8 million in related party notes payable and \$195,000 of discount on the notes related to the relative value of the warrants issued in the transaction that will be amortized to interest expense over the five year life of the note. The fair value of these warrants was determined using the Black-Scholes valuation method with the following assumptions: an expected life of 3 years, an expected stock price volatility of 75%, a risk free interest rate of 2.25%, and a dividend yield of 0%.

On June 29, 2007, we amended and restated the 2002 and 2003 notes with Mr. Roy and he loaned to us an additional \$2.0 million and received additional warrants that allowed him to purchase up to 333,333 shares at \$1.20 per share. In connection with this additional loan we recorded \$1.8 million in related party notes payable and \$187,000 discount on the notes related to the relative value of the warrants issued in the transaction that will be amortized to interest expense over the three-year life of the note. The fair value of these warrants was determined using the Black-Scholes valuation method with the following assumptions: an expected life of 3 years, an expected stock price volatility of 75%, a risk free interest rate of 4.28%, and a dividend yield of 0%. In addition, the amendment extended the maturity date of the previous notes through March 31, 2009. The principal and interest due on the loans as of September 30, 2007 was \$8.4 million. As of September 30, 2007, warrants to purchase 462,099 shares of common stock issued in connection with these finances were vested and outstanding.

*Oak Hill Capital and Ashutosh Roy Notes*

On March 31, 2004, we entered into a note and warrant purchase agreement with Ashutosh Roy, our Chief Executive Officer, Oak Hill Capital Partners L.P., Oak Hill Capital Management Partners L.P., and FW Investors L.P. (the lenders) pursuant to which the lenders loaned to us \$2.5 million evidenced by secured promissory notes and received warrants to purchase shares of our common stock in connection with such loan. The secured promissory notes have a term of five years and bear interest at an effective annual rate of 12% due and payable upon the maturity of such notes. We have the option to prepay the notes at any time subject to the prepayment penalties set forth in such notes. The warrants allow the lenders to purchase up to 312,500 shares at an exercise price of \$2.00. These warrants expired in March 2007. We recorded \$2.3 million in related party notes payable and \$223,000 of discount on the notes related to the relative value of the warrants issued in the transaction that will be amortized to interest expense over the five year life of the notes. The fair value of these warrants was determined using the Black-Scholes valuation method with the following assumptions: an expected life of 3 years, an expected stock price volatility of 75%, a risk free interest rate of 1.93%, and a dividend yield of 0%. The principal and interest due on the loans as of September 30, 2007 was \$3.7 million.

**Note 8. Bank Borrowings**

On October 29, 2004, we entered into a loan and security agreement (the Credit Facility) with Silicon Valley Bank (SVB) which replaced the existing accounts receivable purchase agreement. On December 22, 2006 we entered into an amendment to the Credit Facility that revised the terms to allow for the advance of up to the lesser of \$2.0 million or the sum of 80% of certain qualified receivables and 50% of our unrestricted cash on deposit

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with SVB less the total outstanding obligations to SVB and any outstanding letters of credit. The amendment also revised the interest at a rate of prime plus 1.75% per annum, provided that if we maintain an adjusted quick ratio of greater than 1.40 to 1.00, then the rate will be reduced to a rate of prime plus 1.00%, and extended the termination date to December 22, 2008. As of September 30, 2007, the outstanding balance under the Credit Facility was \$1.8 million, and the interest rate was 9.5%.

In addition, the amendment allows for the advance of up to an additional \$500,000 to be used to finance equipment purchases (the Equipment Line). Each advance under the Equipment Line must be repaid in 24 equal monthly payments of principal and interest, commencing on the first day of the first month following the date the advance is made, and continuing on the first day of each succeeding month. Interest accrues from the date of each advance, under the Equipment Line, at a rate of prime plus 2% per annum. As of September 30, 2007, we had made seven advances under the Equipment Line and there was no available balance for future advances. The amount outstanding under the Equipment Line as of September 30, 2007 was \$399,000 with a weighted average interest rate of 10.30%.

There are financial covenants under this agreement that require us to meet certain minimum tangible net worth requirements during the term of the Credit Facility. As of September 30, 2007 we did not meet the covenants, however SVB has agreed to forbear the non-compliance and has restructured the financial covenants under the agreement.

**Note 9. Income Taxes**

On July 13, 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109* ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement of Financial Accounting Standards ( SFAS ) No. 109, *Accounting for Income Taxes* and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Under FIN 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, FIN 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. Our practice is to recognize interest and/or penalties related to income tax matters in income tax expense.

The adoption of FIN 48 did not have material impact our financial condition, results of operations or cash flows. At June 30, 2007, we had total deferred tax assets of \$76.7 million. The deferred tax assets are primarily composed of federal and state tax net operating loss ( NOL ) carryforwards and federal and state research and development ( R&D ) credit carryforwards. Due to uncertainties surrounding our ability to generate future taxable income to realize these assets, a full valuation has been established to offset the total deferred tax assets.

We are subject to taxation in the US and various state jurisdictions. Our tax years for 2003 and forward are subject to examination by the US and California tax authorities due to the carryforward of unutilized NOL and R&D credits.

**Note 10. Commitments**

We generally warrant that the program portion of our software will perform substantially in accordance with certain specifications for a period up to 180 days. Our liability for a breach of this warranty is either a return of the license fee or providing a fix, patch, work-around or replacement of the software.

We also provide standard warranties against and indemnification for the potential infringement of third party intellectual property rights to our customers relating to the use of our products, as well as indemnification agreements with certain officers and employees under which we may be required to indemnify such persons for liabilities arising out of their duties to us. The terms of such obligations vary. Generally, the maximum obligation is the amount permitted by law.

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Historically, costs related to these warranties have not been significant, however we cannot guarantee that a warranty reserve will not become necessary in the future.

We have also agreed to indemnify our directors and executive officers for costs associated with any fees, expenses, judgments, fines and settlement amounts incurred by any of these persons in any action or proceeding to which any of those persons is, or is threatened to be, made a party by reason of the person's service as a director or officer, including any action by us, arising out of that person's services as director or officer or that person's services provided to any other company or enterprise at our request.

### **Note 11. New Accounting Pronouncements**

In June 2007, EITF issued, Issue No. 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities*. Companies involved in research and development activities may make prepayments for goods or services that will be used in future research and development activities. These fees generally relate to a variety of activities, and the business purpose of these payments varies. In these types of arrangements, a portion of the advanced payment may be refundable; however, it is common for at least a portion of the fees to be non-refundable. The issue is whether non-refundable advance payments for goods that will be used or for services that will be performed in future research and development activities should be accounted for pursuant to FASB Statement No. 2, *Accounting for Research and Development Costs*. We are currently assessing the impact of Issue No. 07-3 on our financial statements.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, ( SFAS 159 ). SFAS 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for the company beginning in the first quarter of fiscal year 2008, although earlier adoption is permitted. We are currently assessing the impact of SFAS 159 on our financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurement*, ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently assessing the impact of SFAS 157 on our financial statements.

### **Note 12. Litigation**

Beginning on October 25, 2001, a number of securities class action complaints were filed against us, and certain of our then officers and directors and underwriters connected with our initial public offering of common stock in the U.S. District Court for the Southern District of New York (*consolidated into In re Initial Public Offering Sec. Litig.*). The complaints alleged generally that the prospectus under which such securities were sold contained false and misleading statements with respect to discounts and excess commissions received by the underwriters as well as allegations of "laddering" whereby underwriters required their customers to purchase additional shares in the aftermarket in exchange for an allocation of IPO shares. The complaints sought an unspecified amount in damages on behalf of persons who purchased the common stock between September 23, 1999 and December 6, 2000. Similar complaints were filed against 55 underwriters and more than 300 other companies and other individuals. The over 1,000 complaints were consolidated into a single action. We reached an agreement with the plaintiffs to resolve the cases as to our liability and that of our officers and directors. The settlement involved no monetary payment or other consideration by us or our officers and directors and no admission of liability. On August 31, 2005, the court issued an order preliminarily approving the settlement and setting a public hearing on its fairness for April 24, 2006 (the postponement from January 2006 to April 2006 was because of difficulties in mailing the required notice to class members). On October 27, 2005, the court issued an order making some minor changes to the form of notice to be sent to class members. On January 17, 2006, the court issued an order modifying the preliminary settlement approval order to extend the time within which notice must be given to the class, which time had expired on January 15, 2006. On April 24, 2006, the Court held a public hearing on the fairness of the proposed settlement. Meanwhile the consolidated case against the underwriters proceeded. In October

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2004, the district court certified a class. On December 5, 2006, however, the Second Circuit reversed, holding that a class could not be certified. In *re* Initial Public Offering Sec. Litig., 471 F.3d 24 (2d Cir. 2006) the Second Circuit's holding, while directly affecting only the underwriters, raised doubt as to whether the settlement class contemplated by the proposed issuer settlement would be approved in its present form. A petition for rehearing was filed January 5, 2007. The Court of Appeals denied a petition for rehearing on April 6, 2007. On June 25, 2007, the district court entered a stipulated order terminating the proposed issuer settlement. Plaintiffs are proceeding with discovery as to underwriters and issuers, although principally with respect to focus or test cases that do not name the Company as a defendant. The court set a briefing schedule for a new class certification motion, which is expected to be heard in early 2008. We have not accrued any liability or expect the outcome of this litigation to have a material impact on our financial condition.

On April 5, 2007, Polaris IP, LLC (Polaris) sued eGain, our subsidiary Inference Corp. and certain eGain Customers for patent infringement in the U.S. District Court for the Eastern District of Texas, Marshall Division, which alleged infringement of US patent Nos. 6,411,947 and 6,278,996. After various motions in this patent infringement case and the filing by eGain of a declaratory judgment action in Minnesota, the parties agreed to a settlement, which occurred on September 27, 2007. eGain and eGain related companies obtained a license to certain Polaris patents on terms that allow the license to continue until the expiration of these patents. The parties agreed to dismiss their claims against each other with prejudice. The terms of the settlement included the release and dismissal of our customers named in the litigation.

With the exception of these matters, we are not a party to any other material pending legal proceedings, nor is our property the subject of any material pending legal proceeding, except routine legal proceedings arising in the ordinary course of our business and incidental to our business, none of which are expected to have a material adverse impact, as taken individually or in the aggregate, upon our business, financial position or results of operations. However, even if these claims are not meritorious, the ultimate outcome of any litigation is uncertain, and it could divert management's attention and impact other resources.

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

*This report on Form 10-Q and the documents incorporated herein by reference contain forward-looking statements that involve risks and uncertainties. These statements may be identified by the use of the words such as anticipates, believes, continue, could, would, estimates, forecasts, expects, intends, may, might, plans, potential, predicts, should, or will and similar expressions or the negative of those terms. The forward-looking statements include, but are not limited to, risks stemming from the uncertainty of demand for eGain products including our guidance regarding revenue; the anticipated customer benefits from eGain products; the actual mix in new business between hosting and license transactions when compared with management's projections; the increased complexity of certain transactions and the timing of revenue recognition on such transactions; the anticipated benefits to eGain from the Cisco OEM agreement; the ability to increase revenues as a result of the increased investment in sales and marketing; increased competition and technological changes in the markets in which eGain competes; and eGain's ability to manage its expenditures. Our actual results could differ materially from those discussed in statements relating to our future plans, product releases, objectives, expectations and intentions, and other assumptions underlying or relating to any of these statements. Factors that could contribute to such differences include those discussed in Factors That May Affect Future Results in our Annual Report on Form 10-K for the fiscal year ended June 30, 2007. These forward-looking statements speak only as of the date hereof. We expressly disclaim any obligation or understanding to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.*

**Overview**

We are a pioneer in, and a leading provider of, customer service and contact center software that enables companies to build customer interaction hubs. An innovative approach to customer service, these hubs reduce customer service costs while enhancing customer experience within and across interaction channels by centralizing interaction history, knowledge management, business rules, analytics, workflow and application management in one platform. Trusted by prominent enterprises and growing mid-sized companies worldwide, eGain's award winning software has been helping organizations achieve and sustain customer service excellence for more than a decade. The company was incorporated in Delaware in September 1997.

**Table of Contents****Critical Accounting Policies and Estimates**

Management's Discussion and Analysis of Financial Condition and Results of Operations discuss our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, management evaluates its estimates and judgments, including those related to revenue recognition, valuation allowance, accrued liabilities, long-lived assets and stock-based compensation. Management bases its estimates and judgments on historical experience and on various other factors 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 two sources: license fees, and support and services. Support and services includes hosting, software maintenance and support and professional services. Maintenance and support consists of technical support and software upgrades and enhancements. Professional services primarily consist of consulting and implementation services and training. Significant management judgments and estimates are made and used to determine the revenue recognized in any accounting period. Material differences may result in the amount and timing of our revenue for any period if different conditions were to prevail.

We apply the provisions of Statement of Position ( SOP ) No. 97-2, *Software Revenue Recognition*, ( SOP 97-2 ) as amended by SOP No. 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*, ( SOP 98-9 ) to all transactions involving the licensing of software products. In the event of a multiple element arrangement for a license transaction we evaluate the transaction as if each element represents a separate unit of accounting taking into account all factors following the guidelines set forth in SOP 97-2, or for a hosting transaction, Emerging Issues Task Force Issue ( EITF ) No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*, ( EITF 00-21 ). For professional services, where the services are not essential to the functionality, the services revenue is recognized in accordance with SOP 97-2. If the services are essential to the functionality, the services revenues are recognized in accordance with the provisions of SOP No. 81-1, *Accounting for Performance of Construction Type and Certain Production Type Contracts*, ( SOP 81-1 ).

When licenses are sold together with system implementation and consulting services, license fees are recognized upon delivery, generally the date of electronic transmission or shipment, provided that (i) payment of the license fees is not dependent upon the performance of the consulting and implementation services, (ii) the services are available from other vendors, (iii) the services qualify for separate accounting as we have sufficient experience in providing such services, have the ability to estimate cost of providing such services, and we have vendor specific objective evidence of pricing, and (iv) the services are not essential to the functionality of the software.

We use signed software license and services agreements and order forms as evidence of an arrangement for sales of software, hosting, maintenance and support. We use signed engagement letters to evidence an arrangement for professional services.

*License Revenue*

We recognize license revenue when persuasive evidence of an arrangement exists, the product has been delivered, no significant obligations remain, the fee is fixed or determinable, and collection of the resulting receivable is probable. In software arrangements that include rights to multiple software products and/or services, and have vendor specific objective evidence on all of the undelivered elements, we use the residual method to recognize revenue. Under the residual method revenue is allocated to the undelivered elements based on vendor specific objective evidence of the fair value of such undelivered elements. The residual amount of revenue is the allocated to the delivered elements and recognized as revenue assuming all other criteria for revenue recognition have been met. Such undelivered elements in these arrangements typically consist of software maintenance and support, implementation and consulting services and in some cases hosting services.

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Software is delivered to customers electronically or on a CD-ROM, and license files are delivered electronically. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction. We have standard payment terms included in our contracts. We assess collectibility based on a number of factors, including the customer's past payment history and its current creditworthiness. If we determine that collection of a fee is not reasonably assured, we defer the revenue and recognize it at the time collection becomes reasonably assured, which is generally upon receipt of cash payment. If an acceptance period is required, revenue is recognized upon the earlier of customer acceptance or the expiration of the acceptance period.

We periodically sell to resellers. License sales to resellers as a percentage of total revenue was approximately 7% for the quarter ended September 30, 2007 compared to a 5% of the total revenue for the comparable year-ago quarter. Revenue from sales to resellers is generally recognized upon delivery to the reseller but depends on the facts and circumstances of the transaction, such as our understanding of the reseller's plans to sell the software, if there are any return provisions, price protection or other allowances, the reseller's financial status and our past experience with the particular reseller. Historically sales to resellers have not included any return provisions, price protections, other allowances, or extended payment terms.

### *Professional Services Revenue*

Included in support and services revenues are revenues derived from system implementation, consulting and training. For license transactions, the majority of our consulting and implementation services and accompanying agreements qualify for separate accounting. We use vendor specific objective evidence of fair value for the services and maintenance to account for the arrangement using the residual method, regardless of any separate prices stated within the contract for each element. Our consulting and implementation service contracts are bid either on a fixed-fee basis or on a time-and-materials basis. Substantially all of our contracts are on a time-and-materials basis. For time-and-materials contracts, where the services are not essential to the functionality of the software, we recognize revenue as services are performed. If the services are essential to functionality, then both the product license revenue and the service revenues are recognized under the percentage of completion method. For a fixed-fee contract where services are not essential to the functionality, we recognize revenue based upon the costs and efforts to complete the services in accordance with the percentage of completion method provided we are able to estimate such cost and efforts. If the fixed fee services are essential to the functionality, we recognize the revenue using contract accounting in accordance with SOP 81-1.

In August 2006, we entered into an OEM agreement with Cisco Systems. Under this agreement we will supply unified communications technology for use in certain Cisco products. Pursuant to the agreement, there are certain minimum royalty payments due to us from Cisco based upon our successful delivery of certain milestones that are projected over the first eighteen months of the agreement. The first major milestone was delivered and accepted in December 2006. The second major milestone was delivered and accepted in August 2007. This OEM agreement with Cisco includes multiple elements, including significant product customizations that are subject to Cisco's acceptance. We have determined that this arrangement should be accounted for under the contract accounting method in accordance with paragraph 65 of SOP 97-2. In addition, we have determined that no loss will be incurred in the arrangement, however, at present the lowest probable level of profit cannot be determined as we are still in the development stage of the agreement, and therefore, a zero estimate of profit is used in calculating revenue. Revenue from this arrangement as a percentage of total revenue was approximately 2% for the three months ended September 30, 2007, and is all related to professional services revenue.

For hosting consulting and implementation services that do not qualify for separate accounting, we recognize the services revenue ratably over the estimated life of the customer hosting relationship.

Training revenue is recognized when training is provided, or in the case of hosting, when the customer also has access to the hosting services, if such training services meet the separable criteria.

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### *Hosting Services Revenue*

Included in support services revenues are revenues derived from our hosted service offerings. We recognize hosting services revenue ratably over the period of the applicable agreement as services are provided. Hosting agreements are typically for a period of one or two years and automatically renew unless either party cancels the agreement. The majority of the hosting services customers purchase a combination of our hosting service and professional services. In some cases the customer may also acquire a license for the software.

We evaluate whether each of the elements in these arrangements represents a separate unit of accounting, as defined by EITF 00-21, using all applicable facts and circumstances, including whether (i) we sell or could readily sell the element unaccompanied by the other elements, (ii) the element has stand-alone value to the customer, (iii) there is objective reliable evidence of the fair value of the undelivered item, and (iv) there is a general right of return. We consider the applicability of EITF No. 00-03, *Application of SOP 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware*, ( EITF 00-03 ) on a contract-by-contract basis. In hosted term-based agreements, where the customer does not have the contractual right to take possession of the software, the revenue is recognized on a monthly basis over the term of the contract. Amounts that are billable are invoiced and recorded in accounts receivable and in deferred revenue or revenue, depending on whether the revenue recognition criteria have been met. For professional services that we determine do not have stand-alone value to the customer, we recognize the services revenue ratably over the longer of the remaining contractual period or the remaining estimated life of the customer hosting relationship, once hosting has gone live. We currently estimate life of the customer hosting relationship to be 20 months, based on the average life of all hosting customer relationships.

If we determine that the customer has the contractual right to take possession of our software at any time during the hosting period without significant penalty, and can feasibly run the software on its own hardware or enter into another arrangement with a third party to host the software, a software element covered by SOP 97-2 exists. When a software element exists in a hosting services arrangement, we recognize the license, professional services and hosting services revenues pursuant to SOP 97-2. We have established vendor specific objective evidence for the hosting and support elements of perpetual license sales, based on the prices charged when sold separately and substantive renewal terms. Accordingly, revenue for the perpetual software license element is determined using the residual method and is recognized upon delivery. Revenue for the hosting and support elements is recognized ratably over the contractual time period. Professional services are recognized as described above under *Professional Services Revenue* . If evidence of fair value cannot be established for the undelivered elements of an agreement, the entire amount of revenue from the arrangement is recognized ratably over the period that these elements are delivered.

### *Maintenance and Support Revenue*

Included in support services revenues are revenues derived from maintenance and support. Maintenance and support revenue is recognized ratably over the term of the maintenance contract, which is typically one year. Maintenance and support is renewable by the customer on an annual basis. Rates for maintenance and support, including subsequent renewal rates, are typically established based upon a specified percentage of net license fees as set forth in the arrangement.

### *Stock-Based Compensation*

We apply the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123 (revised 2004), *Share-Based Payment*, ( SFAS 123R ) to all options granted after the adoption of SFAS 123R. SFAS 123R is a very complex accounting standard, the application of which requires significant judgment and the use of estimates, particularly surrounding Black-Scholes assumptions such as stock price volatility and expected option lives, as well as expected option forfeiture rates to value equity-based compensation. We determine the appropriate measure of expected volatility by reviewing historic volatility in the share price of our common stock. We base our assumptions for forfeiture rates on our historic activity. We used a temporary shortcut approach to develop the estimate of the expected life of a plain vanilla employee stock option. Under this approach, the expected life would be presumed to be the mid-point between the vesting date and the end of the contractual term. SFAS 123R also requires that the benefit of tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement reduces net operating cash flows and increases net financing cash flows in periods after the effective date. This tax difference for unexercised options must also be recorded as a deferred tax item and recorded in additional paid in capital.

**Table of Contents***Valuation of Goodwill*

We review goodwill annually for impairment (or more frequently if impairment indicators arise). We perform an annual goodwill impairment review at April 1 every year, and we have found no impairment in the last three years. Additionally, we did not identify any indicators which made us believe goodwill was potentially impaired during the quarter ended September 30, 2007.

*Allowance for Doubtful Accounts*

We maintain an allowance for doubtful accounts to reserve for potentially uncollectible trade receivables. We review our trade receivables by aging category to identify specific customers with known disputes or collectability issues. We exercise judgment when determining the adequacy of these reserves as we evaluate historical bad debt trends, general economic conditions in the U.S. and internationally, and changes in customer financial conditions. If we make different judgments or utilized different estimates, material differences may result in additional reserves for trade receivables, which would be reflected by charges in general and administrative expenses for any period presented.

**Results of Operations**

The following table sets forth the results of operations for the periods presented (unaudited), expressed as a percentage of total revenue:

|                                      | <b>Three Months Ended<br/>September 30,</b> |             |
|--------------------------------------|---|-------------|
|                                      | <b>2007</b>                                 | <b>2006</b> |
| <b>Revenue:</b>                      |   |             |
| License                              | 22%   | 27%         |
| Support and services                 | 78%   | 73%         |
| <br>                                 |   |             |
| Total revenue                        | 100%  | 100%        |
| Cost of license                      | 0%  | 1%          |
| Cost of support and services         | 41%   | 32%         |
| <br>                                 |   |             |
| Gross profit                         | 59%   | 67%         |
| <b>Operating costs and expenses:</b> |   |             |
| Research and development             | 18%   | 17%         |
| Sales and marketing                  | 49%   | 55%         |
| General and administrative           | 22%   | 16%         |
| <br>                                 |   |             |
| Total operating costs and expenses   | 89%   | 88%         |
| <br>                                 |   |             |
| Loss from operations                 | (30)%                                       | (21)%       |

**Revenues**

Total revenue increased 8% to \$6.5 million in the quarter ended September 30, 2007 from \$6.0 million in the quarter ended September 30, 2006. The increase was primarily due to the increase in support and services revenue related to the increased size of contracts. During the three months ended September 30, 2007, there was no customer that accounted for 10% of total revenue and there was one customer Caremark Rx, Inc. that accounted for 13% of total revenue in the comparable year-ago quarter.

We are continuing to see increased interest from medium to large-sized companies in our customer interaction solutions. Based upon this interest and our recent increases in sales and marketing activities, we anticipate total revenue to increase over the next fiscal year. There is however general unpredictability of the length of our current sales cycles, the timing of revenue recognition on more complex license transactions and seasonal buying patterns. For example, in the fourth quarter of fiscal year 2007 we deferred license revenue of \$2.1 million due to the complexity of three large transactions, of which \$449,000 was recognized in the first fiscal quarter in





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2008. Also, because we offer a hybrid delivery model, the mix of new hosting and license business in a quarter could also have an impact on our revenue in a particular quarter. We are continuing to see a shift towards hosting by our target customers. For license transactions, the license revenue amount is generally recognized in the quarter which delivery and acceptance of our software takes place whereas, for hosting transactions, hosting revenue is recognized ratably over the term of the hosting contract, which is typically one to two years. As a result, our total revenue may increase or decrease in future quarters as a result of the timing and mix of license and hosting transactions.

**License**

| (unaudited, in thousands)   | Three Months Ended |                    |          |       |
|-----------------------------|--------------------|--------------------|----------|-------|
|                             | 2007               | September 30, 2006 | Change   | %     |
| <b>Revenue:</b>             |                    |                    |          |       |
| License                     | \$ 1,423           | \$ 1,635           | \$ (212) | (13)% |
| Percentage of total revenue | 22%                | 27%                |          |       |

License revenue decreased 13% to \$1.4 million in the quarter ended September 30, 2007 from \$1.6 million in the quarter ended September 30, 2006. The decrease was primarily due in part to the shift in our customer's buying patterns resulting in an increase in new hosting business. There were two large license transactions totaling approximately \$842,000 in the quarter compared to three large transactions totaling approximately \$1.2 million in the same quarter a year ago. License revenue recognized from deferred revenue was \$449,000 in the quarter, an increase of \$198,000 from the same quarter last year. License revenue represented 22% and 27% of total revenue for the quarters ended September 30, 2007 and 2006, respectively.

Given the general unpredictability of the length of current sales cycles and the mix between hosting and license business, license revenue may increase or decrease in future but we anticipate license revenues to increase in fiscal year 2008 compared to license revenue recorded in fiscal year 2007.

**Support and Services**

| (unaudited, in thousands)   | Three Months Ended |                    |        |      |
|-----------------------------|--------------------|--------------------|--------|------|
|                             | 2007               | September 30, 2006 | Change | %    |
| <b>Revenue:</b>             |                    |                    |        |      |
| Hosting services            | \$ 1,278           | \$ 1,020           | \$ 258 | 25%  |
| Maint. and support services | \$ 2,179           | \$ 2,170           | \$ 9   | 0.4% |
| Professional services       | \$ 1,591           | \$ 1,178           | \$ 413 | 35%  |
| Total support and services  | \$ 5,048           | \$ 4,368           | \$ 680 | 16%  |
| Percentage of total revenue | 78%                | 73%                |        |      |

Support and services revenue includes hosting, software maintenance and support and professional services. Maintenance and support services consist of technical support and software upgrades and enhancements. Professional services primarily consist of consulting and implementation services and training. Support and services revenue increased 16% to \$5.0 million in the quarter ended September 30, 2007 from \$4.4 million in the quarter ended September 30, 2006. The increase was primarily due to the increase in hosting revenue and professional services revenue. Support and services revenue represented 78% and 73% of total revenue for the quarters ended September 30, 2007 and 2006, respectively.

Hosting revenue increased 25% to \$1.3 million in the quarter ended September 30, 2007 from \$1.0 million in the quarter ended September 30, 2006. The increase was primarily due to the increased size of new hosting contracts with larger enterprises recorded in fiscal year 2007. There were two new large hosting contracts totaling over \$2.5 million in fiscal year 2007 which started generating quarterly revenue of approximately \$260,000 in recent quarters. We expect hosting revenue to increase in future periods based upon current renewal rates for existing hosted customers, the new hosting agreements entered into in recent quarters that we expect to start generating hosting revenue in future quarters and the increased interest we are seeing for our hosting or on demand services from our target customers.



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Maintenance and support revenue increased \$9,000 in the quarter ended September 30, 2007 compared to the quarter ended September 30, 2006. We expect maintenance and support revenue to increase in future periods based upon the current renewal rates for existing maintenance and support customers and the projected levels of new license sales.

Professional services revenue increased 35% to \$1.6 million in the quarter ended September 30, 2007 from \$1.2 million in the quarter ended September 30, 2006. The increase in the quarter was primarily due to (i) the increase in multi-application sales and larger customer deployments contributed to an increase of approximately \$228,000 in North America and (ii) approximately \$135,000 of services delivered associated with the OEM Agreement we entered into with Cisco Systems in August 2006.

Based upon our current sales pipeline, the ongoing services related to the Cisco OEM agreement and sales strategy we do expect professional services revenue to increase in future periods.

**Cost of Revenues**

| (unaudited, in thousands)   | Three Months Ended |          |        |     |
|-----------------------------|--------------------|----------|--------|-----|
|                             | 2007               | 2006     | Change | %   |
| Cost of Revenues            | \$ 2,695           | \$ 1,982 | \$ 713 | 36% |
| Percentage of total revenue | 41%                | 33%      |        |     |

Total cost of revenue increased 36% to \$2.7 million in the quarter ended September 30, 2007 from \$2.0 million in the quarter ended September 30, 2006. Total cost of revenue represented 41% and 33% of total revenues in the quarter ended September 30, 2007 and 2006, respectively. The increase in the quarter was primarily due to (i) increased personnel and personnel-related expenses of \$319,000 from the additional headcount from our operations in North America and India, (ii) an outside consulting expense of \$120,000 for services subcontracted through a partner in Europe, (iii) an increase in international subsidiaries expenses of approximately \$109,000 related to the strengthening of the European and Indian currencies against U.S. dollar, (iv) the research and development personnel cost related to the Cisco OEM agreement of approximately \$80,000 and (v) the increase in hosting related cost of approximately \$67,000.

In order to better understand the changes within our cost of revenues and resulting gross margins, we have provided the following discussion of the individual components of our cost of revenues.

**Cost of License**

| (unaudited, in thousands)     | Three Months Ended |       |         |       |
|-------------------------------|--------------------|-------|---------|-------|
|                               | 2007               | 2006  | Change  | %     |
| Cost of License               | \$ 20              | \$ 41 | \$ (21) | (51)% |
| Percentage of license revenue | 1%                 | 3%    |         |       |
| Gross Margin                  | 99%                | 97%   |         |       |

Cost of license is the cost for third-party software imbedded in our products. Total cost of license decreased 51% to \$20,000 in the quarter ended September 30, 2007 from \$41,000 in the quarter ended September 30, 2006. Total cost of license as a percentage of total license revenues decreased to 1% (a gross margin of 99%) in the quarter ended September 30, 2007 from 3% (a gross margin of 97%) in the quarter ended September 30, 2006.

We anticipate cost of license to remain relatively constant in future periods.

**Table of Contents**Cost of Support and Services

| (unaudited, in thousands)                 | Three Months Ended<br>September 30, |          |        |     |
|---|-------------------------------------|----------|--------|-----|
|   | 2007                                | 2006     | Change | %   |
| <b>Cost of support and services</b>       | \$ 2,675                            | \$ 1,941 | \$ 734 | 38% |
| Percentage of support and service revenue | 53%                                 | 44%      |        |     |
| Gross Margin                              | 47%                                 | 56%      |        |     |

Cost of support and services includes personnel costs for our hosting services, consulting services and customer support. It also includes depreciation of capital equipment used in our hosted network, cost of support for the third-party software and lease costs paid to remote co-location centers. In addition, as the Cisco OEM arrangement is being accounted for under the contract accounting method in accordance with paragraph 65 of SOP 97-2 and a zero estimate of profit is being used in calculating revenue, we recorded costs associated with this agreement of approximately \$135,000 for the quarter ended September 30, 2007 and there was no related costs recorded for the comparable year-ago quarter. The services delivered in connection with this agreement were performed by research and development personnel totaling approximately \$80,000 and the remainder performed by services personnel totaling approximately \$55,000.

Total cost of support and services increased 38% to \$2.7 million in the quarter ended September 30, 2007 from \$1.9 million in the quarter ended September 30, 2006. The increase in the quarter was primarily due to (i) increased personnel and personnel-related expenses of \$319,000 from the additional headcount from our operations in North America and Europe, (ii) an outside consulting expense of \$120,000 for services subcontracted through a partner in Europe, (iii) an increase in European expenses of approximately \$109,000 related to the strengthening of the European and India currencies against the U.S. dollar, (iv) the research and development personnel cost related to the Cisco OEM agreement of approximately \$80,000 and (v) the increase in hosting related cost of approximately \$67,000.

Based upon current revenue expectations, we anticipate cost of support and services to increase in absolute dollars in future periods. While we continue to account for the Cisco OEM agreement under a zero estimate of profit, the gross margins are subject to fluctuate based upon the level of Cisco-related services.

**Research and Development**

| (unaudited, in thousands)       | Three Months Ended<br>September 30, |          |        |     |
|---------------------------------|-------------------------------------|----------|--------|-----|
|                                 | 2007                                | 2006     | Change | %   |
| <b>Research and Development</b> | \$ 1,144                            | \$ 1,025 | \$ 119 | 12% |
| Percentage of total revenue     | 18%                                 | 17%      |        |     |

Research and development expenses primarily consist of compensation and benefits for our engineering, product management and quality assurance personnel, fees for outside consultants and, to a lesser extent, occupancy costs and related overhead. Research and development costs increased 12% to \$1.1 million in the quarter ended September 30, 2007 from \$1.0 million in the quarter ended September 30, 2006. Total research and development expenses as a percentage of total revenues were 18% in the quarter ended September 30, 2007 compared to 17% in the quarter ended September 30, 2006. The increase in the quarter was primarily due to (i) increased personnel and personnel-related costs of \$109,000 from compensation adjustments and increased headcount in North America, (ii) an increase in international expenses of approximately \$73,000 related to the strengthening of the European and Indian currencies against U.S. dollar and was partially offset by \$80,000 for the services performed by research and development personnel in connection with the Cisco OEM agreement charged to cost of support and services. The increase is consistent with our continued commitment to invest in product innovation.

Based upon our current product development plans we anticipate an increase in research and development expense in fiscal year 2008, primarily due to an increase in personnel costs.

**Table of Contents****Sales and Marketing**

| (unaudited, in thousands)        | Three Months Ended |          |          |      |
|----------------------------------|--------------------|----------|----------|------|
|                                  | September 30,      |          |          |      |
|                                  | 2007               | 2006     | Change   | %    |
| <b>Sales</b>                     | \$ 2,573           | \$ 2,700 | \$ (127) | (5)% |
| <b>Marketing</b>                 | \$ 568             | \$ 587   | \$ (19)  | (3)% |
| <b>Total Sales and Marketing</b> | \$ 3,141           | \$ 3,287 | \$ (146) | (4)% |
| Percentage of total revenue      | 49%                | 55%      |          |      |

Sales and marketing expenses primarily consist of compensation and benefits for our sales, marketing and business development personnel, lead generation activities, advertising, trade show and other promotional costs and, to a lesser extent, occupancy costs and related overhead. Sales and marketing expense decreased 4% to \$3.1 million in the quarter ended September 30, 2007 from \$3.3 million in the quarter ended September 30, 2006. Total sales and marketing expenses as a percentage of total revenues was 49% in the quarter ended September 30, 2007 compared to 55% in the quarter ended September 30, 2006.

Total sales expenses decreased 5% to \$2.6 million in the quarter ended September 30, 2007 from \$2.7 million in the quarter ended September 30, 2006. The decrease in the quarter was primarily due to (i) the decrease in personnel and personnel related costs of approximately \$127,000 from the reduction in headcount, and (ii) the decrease in outside consulting expense of \$83,000 that was partially offset by the increase in international subsidiaries expenses of approximately \$94,000 related to the strengthening of the European and India currencies against the U.S. dollar.

Total marketing expenses decreased 3% to \$568,000 in the quarter ended September 30, 2007 from \$587,000 in the quarter ended September 30, 2006. The decrease in the quarter was primarily due to the decrease of \$74,000 in marketing program and was partially offset by the increase in international subsidiaries expenses of approximately \$23,000 related to the strengthening of the European and India currencies against the U.S. dollar.

**General and Administrative**

| (unaudited, in thousands)         | Three Months Ended |        |        |     |
|-----------------------------------|--------------------|--------|--------|-----|
|                                   | September 30,      |        |        |     |
|                                   | 2007               | 2006   | Change | %   |
| <b>General and Administrative</b> | \$ 1,423           | \$ 940 | \$ 483 | 51% |
| Percentage of total revenue       | 22%                | 16%    |        |     |

General and administrative expenses primarily consist of compensation and benefits for our finance, human resources, administrative and legal services personnel, fees for outside professional services, provision for doubtful accounts and, to a lesser extent, occupancy costs and related overhead.

General and administrative expense increased 51% to \$1.4 million in the quarter ended September 30, 2007 from \$940,000 in the quarter ended September 30, 2006. Total general and administrative expenses as a percentage of total revenues was 22% in the quarter ended September 30, 2007 compared to 16% in the quarter ended September 30, 2006. The increase in general and administrative expense in the quarter was primarily due to (i) increased legal expense of \$359,000 that was primarily related to the patent lawsuit that was settled in September 2007, see Note 12. Litigation, for further details, (ii) an increase of \$60,000 in additional auditing fees related to cost overruns for the annual audit for fiscal year 2007 and an increase to outside consulting services of \$34,000 required for compliance with the new FIN 48 accounting pronouncement that we adopted this quarter, (iii) an increase of \$40,000 in personnel expenses related to additional headcount and compensation increase for the North America and India operations, and (iv) the increase in international subsidiaries expenses of approximately \$36,000 related to the strengthening of the European and Indian currencies against the U.S. dollar and was partially offset by a decrease in bad debt expense of \$130,000 due to our collection efforts and overall reduced receivables balances.

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Based upon current revenue expectations and the settlement of the patent lawsuit in September 2007, we anticipate general and administrative expenses to decrease in the second fiscal quarter in 2008.

**Stock-Based Compensation**

| (unaudited, in thousands)             | Three Months Ended<br>September 30, |              |             |            |
|---------------------------------------|-------------------------------------|--------------|-------------|------------|
|                                       | 2007                                | 2006         | Change      | %          |
| Cost of support and services          | \$ 11                               | \$ 14        | (3)         | 21%        |
| Research and development              | 11                                  | 11           | 0           | 0%         |
| Sales and marketing                   | 22                                  | 31           | (9)         | 29%        |
| General and administrative            | 9                                   | 19           | (10)        | (53)%      |
| <b>Total Stock-Based Compensation</b> | <b>\$ 53</b>                        | <b>\$ 75</b> | <b>(22)</b> | <b>29%</b> |
| Percentage of total revenue           | 1%                                  | 1%           |             |            |

Stock compensation expenses include the amortization of the fair value of share-based payments made to employees, directors and consultants, primarily in the form of stock options (see Note 3 – Stock-Based Compensation). The fair value of stock options granted is recognized as an expense as the underlying stock options vest.

Based upon recent and anticipated option grants, we do not expect our stock compensation expense to increase significantly in the three months ended December 31, 2007.

**Loss From Operations**

| (unaudited, in thousands) | Three Months Ended<br>September 30, |            |          |       |
|---------------------------|-------------------------------------|------------|----------|-------|
|                           | 2007                                | 2006       | Change   | %     |
| Operating Income / (Loss) | \$ (1,932)                          | \$ (1,231) | \$ (701) | (57)% |
| Operating Margin          | (30)%                               | (21)%      |          |       |

Loss from operations was \$1.9 million in the quarter ended September 30, 2007 compared to a loss of \$1.2 million in the quarter ended September 30, 2006. The operating margin was a negative 30% in the quarter ended September 30, 2007 compared to a negative 21% in the quarter ended September 30, 2006. The operating loss in the quarter was primarily related to (i) the increased personnel-related costs of \$365,000 from our investment in research and development and expansion of the consulting team, (ii) the legal expense of \$359,000 primarily related to the patent lawsuit and (iii) the impact of fluctuation in foreign exchange rates resulting in \$189,000 loss from operations in international subsidiaries due to the strengthening of the European and Indian currencies against the US dollar.

**Interest Expense**

Interest expense increased 50% to \$404,000 in the quarter ended September 30, 2007 from \$270,000 in the quarter ended September 30, 2006. The increase was primarily due to the increase in the related party notes balances.

**Income Tax Expense**

Income tax expense was \$106,000 for the quarter ended September 30, 2007 compared to \$15,000 in the comparable year ago quarter.

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**Table of Contents****Liquidity and Capital Resources***Overview*

As of September 30, 2007 our cash and cash equivalents were \$3.6 million compared to \$6.2 million and the negative working capital was \$6.2 million compared to a negative working capital of \$4.1 million on June 30, 2007. As of September 30, 2007, our current liabilities included \$6.1 million of current deferred revenue compared to \$5.5 million on June 30, 2007. Based upon our fiscal year 2008 plan, we believe that existing capital resources will enable us to maintain current and planned operations for at least the next four quarters. However, if we do not experience the anticipated demand for our products, we will need to reduce costs, issue equity securities or borrow money to meet our cash requirements. From time to time, however, we may consider opportunities for raising additional capital and/or exchanging all or a portion of our existing debt for equity. We can make no assurances that such opportunities will be available to us on economic terms we consider favorable, if at all.

If adequate funds are not available on acceptable terms, our ability to achieve or sustain positive cash flows, maintain current operations, fund any potential expansion, take advantage of unanticipated opportunities, develop or enhance products or services, or otherwise respond to competitive pressures would be significantly limited. Our expectations as to our future cash flows and our future cash balances are subject to a number of assumptions, including assumptions regarding anticipated increases in our revenue, the mix of new hosting and license business, our ability to retain existing customers and customer purchasing and payment patterns, many of which are beyond our control.

On June 29, 2007 we entered into an agreement that amends and restates outstanding notes issued to Mr. Roy. Pursuant to this amendment, Mr. Roy loaned to us an additional \$2.0 million and extended the maturity date of the previous notes through March 31, 2009. The principal and interest due on the loans as of September 30, 2007 was \$8.4 million. As of September 30, 2007, warrants to purchase 462,099 shares of common stock were vested and outstanding.

On December 22, 2006, we entered into an amendment to our loan and security agreement (the Credit Facility ) with Silicon Valley Bank ( SVB ) (See Note 8 Bank Borrowings). The Credit Facility provides for the advance of up to the lesser of \$2.0 million or the sum of 80% of certain qualified receivables and 50% of our unrestricted cash on deposit with SVB less the total outstanding obligations to SVB and any outstanding letters of credit. In addition, the amendment allows for the advance of up to an additional \$500,000 to be used to finance equipment purchases. There are financial covenants under this agreement that require us to meet certain minimum tangible net worth requirements during the term of the Credit Facility. As of September 30, 2007 we did not meet the covenants, however, SVB has agreed to forbear the non-compliance and has restructured the financial covenants under the agreement.

On March 31, 2004, we entered into a note and warrant purchase agreement with Mr. Roy, Oak Hill Capital Partners L.P., Oak Hill Capital Management Partners L.P., and FW Investors L.P. pursuant to which they loaned to us \$2.5 million evidenced by secured promissory notes and received warrants to purchase shares of our common stock in connection with such loan. The principal and interest due on the loans as of September 30, 2007 was \$3.7 million. As of September 30, 2007, no warrants were outstanding.

*Cash Flows*

Net cash used in operating activities was \$2.2 million for the quarter ended September 30, 2007 compared to net cash used in operating activities of \$1.5 million for the quarter ended September 30, 2006. This consisted primarily of a net loss of \$2.4 million offset by depreciation \$191,000 and accrued interest amortization of discount on related party notes of \$392,000 and stock-based compensation of \$53,000 and the net increase in operating assets and liabilities.

The net change in operating assets and liabilities for the quarter ended September 30, 2007 primarily consisted of the increase in accounts receivable by \$1.3 million due to the two large license transactions recorded at the end of the quarter, an increase of \$173,000 in other assets and a decrease of \$276,000 in accrued compensation primarily due to the reduced commissions. This was partially offset by the increases in deferred revenue by \$538,000, accrued liabilities by \$200,000, accounts payable by \$218,000 and a decrease of \$240,000 in prepaids and other current assets. The deferred revenue primarily consists of increases in deferred hosting and consulting services which was due to an increase in prepayments from larger hosting customers and an increase in deferred hosting implementation



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services that will be recognized over the estimated life of the hosting arrangements. The increase in accrued liabilities was primarily due to the increased tax accruals. Accounts payable increase was related to the increased operating costs and expense from the investments in our business and increased legal expense of \$359,000 primarily related to the patent lawsuit.

Net cash used in investing activities was \$165,000 for the quarter ended September 30, 2007 compared to net cash used in investing activities of \$83,000 for the comparable year-ago quarter. Cash used in investing activities for the quarter was due to the purchases of equipment primarily related to our hosting infrastructure. Cash used in investing activities for the comparable year-ago quarter was primarily for the replacement of old equipment for worldwide operations and purchase of equipment for our new office in India.

Net cash used in financing activities was \$309,000 for the quarter ended September 30, 2007 compared to net cash used in financing activities of \$52,000 for the quarter ended September 30, 2006. Cash used in financing activities consisted primarily of the payments on existing bank borrowings and partially offset by proceeds from new bank borrowing. The cash used in financing activities for the quarter was due to the decrease in bank borrowing.

*Commitments*

The following table summarizes eGain's contractual obligations, including interest payments accrued for the related party notes payable, as of September 30, 2007 and the effect such obligations are expected to have on its liquidity and cash flow in future periods (unaudited, in thousands):

|                             | Year Ended June 30, |                  |               |               |               |               | Total            |
|-----------------------------|---------------------|------------------|---------------|---------------|---------------|---------------|------------------|
|                             | 2008                | 2009             | 2010          | 2011          | 2012          | Thereafter    |                  |
| Operating leases            | \$ 656              | \$ 733           | \$ 449        | \$ 276        | \$ 105        | \$ 447        | \$ 2,666         |
| Bank borrowings             | 2,149               |                  |               |               |               |               | 2,149            |
| Related party notes payable |                     | 14,614           |               |               |               |               | 14,614           |
| Co-location                 | 220                 | 45               |               |               |               |               | 265              |
| <b>Total</b>                | <b>\$ 3,025</b>     | <b>\$ 15,392</b> | <b>\$ 449</b> | <b>\$ 276</b> | <b>\$ 105</b> | <b>\$ 447</b> | <b>\$ 19,694</b> |

In connection with the related party notes payable, the total interest payable of \$6.1 million will be due in fiscal year 2009.

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**Additional Factors That May Affect Future Results**

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We develop products in the United States and India and sell these products internationally. Generally, sales are made in local currency. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. To date, the effect of changes in foreign currency exchange rates on revenues and operating expenses has not been material. Identifiable assets denominated in foreign currency at September 30, 2007 totaled approximately \$3.5 million. We do not currently use derivative instruments to hedge against foreign exchange risk. As such we are exposed to market risk from fluctuations in foreign currency exchange rates, principally from the exchange rate between the U.S dollar and the Euro and the British pound and the Rupee. Based on our overall foreign currency rate exposure at September 30, 2007, we do not believe that a hypothetical 10% change in foreign currency rates would have a material adverse affect on our financial position or results of operations.

**Item 4. Controls and Procedures**

(a) *Evaluation of disclosure controls and procedures.* We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation as of September 30, 2007, our Chief Executive Officer and Chief Financial Officer have concluded that, subject to the limitations noted above, our disclosure controls and procedures were effective to ensure that material information relating to us, including our consolidated subsidiaries, was made known to them by others within those entities, particularly during the period in which this Quarterly Report on Form 10-Q was being prepared.

(b) *Changes in internal controls.* There were no changes in our internal controls which occurred during our first fiscal quarter of 2008 that have materially affected or are reasonably likely to materially affect our internal controls over financial reporting.

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**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

Beginning on October 25, 2001, a number of securities class action complaints were filed against us, and certain of our then officers and directors and underwriters connected with our initial public offering of common stock in the U.S. District Court for the Southern District of New York (*consolidated into In re Initial Public Offering Sec. Litig.*). The complaints alleged generally that the prospectus under which such securities were sold contained false and misleading statements with respect to discounts and excess commissions received by the underwriters as well as allegations of "laddering" whereby underwriters required their customers to purchase additional shares in the aftermarket in exchange for an allocation of IPO shares. The complaints sought an unspecified amount in damages on behalf of persons who purchased the common stock between September 23, 1999 and December 6, 2000. Similar complaints were filed against 55 underwriters and more than 300 other companies and other individuals. The over 1,000 complaints were consolidated into a single action. We reached an agreement with the plaintiffs to resolve the cases as to our liability and that of our officers and directors. The settlement involved no monetary payment or other consideration by us or our officers and directors and no admission of liability. On August 31, 2005, the court issued an order preliminarily approving the settlement and setting a public hearing on its fairness for April 24, 2006 (the postponement from January 2006 to April 2006 was because of difficulties in mailing the required notice to class members). On October 27, 2005, the court issued an order making some minor changes to the form of notice to be sent to class members. On January 17, 2006, the court issued an order modifying the preliminary settlement approval order to extend the time within which notice must be given to the class, which time had expired on January 15, 2006. The underwriter defendants filed further objections to the settlement on March 20, 2006 and asked that the April 24, 2006 final settlement approval hearing be postponed until after the Second Circuit rules on the underwriters' appeal from the Court's class certification order (which appeal is briefed and awaiting oral argument). On March 29, 2006, the Court denied the request, stating that it would address the underwriters' points at the April 24, 2006 hearing. On April 24, 2006, the Court held a public hearing on the fairness of the proposed settlement. Meanwhile the consolidated case against the underwriters has proceeded. In October 2004, the district court certified a class. On December 5, 2006, however, the Second Circuit reversed, holding that a class could not be certified. In *re Initial Public Offering Sec. Litig.*, 471 F.3d 24 (2d Cir. 2006), the Second Circuit's holding, while directly affecting only the underwriters, raised some doubt as to whether the settlement class contemplated by the proposed issuer settlement will be approved in its present form. A petition for rehearing was filed January 5, 2007. The court of appeals denied a petition for rehearing on April 6, 2007. On June 25, 2007, the district court entered a stipulated order terminating the proposed issuer settlement. Plaintiffs are proceeding with discovery as to underwriters and issuers, although principally with respect to focus or test cases that do not name the Company as a defendant. The court set a briefing schedule for a new class certification motion, which is expected to be heard in early 2008. We have not accrued any liability or expect the outcome of this litigation to have a material impact on our financial condition.

On April 5, 2007, Polaris IP, LLC ( "Polaris" ) sued eGain, our subsidiary Inference Corp. and certain eGain Customers for patent infringement in the U.S. District Court for the Eastern District of Texas, Marshall Division, which alleged infringement of US patent Nos. 6,411,947 and 6,278,996. After various motions in this patent infringement case and the filing by eGain of a declaratory judgment action in Minnesota, the parties agreed to a settlement, which occurred on September 27, 2007. eGain and eGain related companies obtained a license to certain Polaris patents on terms that allow the license to continue until the expiration of these patents. The parties agreed to dismiss their claims against each other with prejudice. The terms of the settlement included the release and dismissal of our customers named in the litigation.

With the exception of these matters, we are not a party to any other material pending legal proceedings, nor is our property the subject of any material pending legal proceeding, except routine legal proceedings arising in the ordinary course of our business and incidental to our business, none of which are expected to have a material adverse impact, as taken individually or in the aggregate, upon our business, financial position or results of operations. However, even if these claims are not meritorious, the ultimate outcome of any litigation is uncertain, and it could divert management's attention and impact other resources.

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**Item 1A. Risk Factors**

In addition to other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A Risk Factors in our Annual Report on Form 10-K for the fiscal year ended June 30, 2007, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing eGain. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

None.

**Item 6. Exhibits**

| <b>Exhibits No.</b> | <b>Description of Exhibits</b>  |
|---------------------|---|
| 31.1                | Rule 13a-15(e)/15d-15(e) Certification of Chief Executive Officer.  |
| 31.2                | Rule 13a-15(e)/15d-15(e) Certification of Chief Financial Officer.  |
| 32.1                | Certification pursuant to 18.U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002 of Ashutosh Roy, Chief Executive Officer.* |
| 32.2                | Certification pursuant to 18.U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002 of Eric Smit, Chief Financial Officer.*    |

\* The material contained in this exhibit is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of the company under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after date hereof and irrespective of any general incorporation language contained in such filing.

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**SIGNATURES**

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

Dated: November 14, 2007

eGAIN COMMUNICATIONS CORPORATION

By /s/ Eric N. Smit  
Eric N. Smit  
Chief Financial Officer  
(Duly Authorized Officer and  
Principal Financial and Accounting Officer)

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