ELOYALTY CORP
Form 10-K
March 11, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

(Mark One)

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 27, 2008

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________

Commission file number 0-27975

eLoyalty Corporation

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**36-4304577**
(State or other Jurisdiction of Incorporation or Organization)	***(I.R.S. Employer Identification No.)***

150 Field Drive, Suite 250

Lake Forest, Illinois 60045

(Address of Registrant s Principal Executive Offices) (Zip Code)

Registrant s telephone number, including area code: (847) 582-7000

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, par value $0.01 per share	**The NASDAQ Stock Market LLC**
Preferred Stock Purchase Rights	**None**

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

Large accelerated filer ¨	Accelerated filer x	Non-accelerated filer ¨	Smaller reporting company ¨

(Do not check if a smaller reporting company)
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No x

The aggregate market value of Common Stock held by non-affiliates of the registrant, based upon the closing price per share of registrant s Common Stock on June 27, 2008, as reported by The NASDAQ Stock Market LLC, is approximately $50,783,512.

The number of shares of the registrant s Common Stock, $0.01 par value per share, outstanding as of March 2, 2009 was 14,160,016.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of eLoyalty s Proxy Statement for its 2009 Annual Meeting of Stockholders, to be filed within 120 days after the end of eLoyalty s fiscal year, are incorporated herein by reference into Part III where indicated.

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PART I

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PART I

Item 1. ***Business.***
Overview

eLoyalty Corporation (together with its subsidiaries and predecessors eLoyalty, we, us, or the Company) helps its clients achieve breakthroug results with revolutionary analytics and advanced technologies that drive continuous business improvement. With a long track record of delivering proven solutions for many of the *Fortune* 1000 Companies, the Company s offerings include the Behavioral Analytics Service, Integrated Contact Solutions and Consulting Services, aligned to enable focused business transformation.

The Company is focused on growing and developing its business through two primary Business Units: the Behavioral Analytics Service and Integrated Contact Solutions/CRM. Through these Business Units, the Company generates three types of revenue: (1) Managed services revenue, which is recurring, annuity revenue from long-term (generally one- to five-year) contracts; (2) Consulting services revenue, which is generally project-based and sold on a time and materials or fixed-fee basis; and (3) Product revenue, which is generated through the resale of third-party software and hardware. The chart below shows the relationship between these Business Units and the types of revenue generated from each.

	Managed Services Revenue	Consulting Services Revenue	Product Revenue
Behavioral Analytics Service Business Unit	Subscription and amortized deployment revenue and marketing application hosting and email fulfillment revenue	Assessments and follow-on consulting revenue	None
Integrated Contact Solutions/CRM Business Unit	Contact center monitoring and support revenue and remote application support revenue	Implementation and follow-on consulting revenue and traditional CRM consulting revenue	Hardware and software resale revenue, primarily from products of Cisco Systems

In recent years, the Company has invested to develop the following differentiated capabilities in our primary Business Units:

Behavioral Analytics Service Business Unit

Behavioral Analytics™ Service

eLoyalty pioneered this solution, which improves the reliability of call recording and applies human behavioral modeling to analyze and improve customer interactions. Using the Behavioral Analytics Service, eLoyalty can help clients:

- Automatically measure customer satisfaction and agent performance on every call;
- Identify and understand customer personality;

Improve rapport between agent and customer;

Reduce call handle times while improving customer satisfaction;

Identify opportunities to improve self-service applications;

Improve cross-sell and up-sell success rates; and

Improve the efficiency and effectiveness of collection efforts.

eLoyalty has designed a scalable application platform to enable the Company to implement and operate the Behavioral Analytics Service for its clients. The Behavioral Analytics Service is primarily hosted by eLoyalty and delivered as a managed subscription service. Consulting services revenue consists of assessment services and Managed services revenue consists of deployment and subscription services.

Marketing Managed Services

Marketing Managed Services revenue is derived from marketing application hosting and email fulfillment services.

Integrated Contact Solutions/CRM Business Unit

Integrated Contact Solutions Service Line

The Company s Integrated Contact Solutions Service Line focuses on helping clients realize the benefits of transitioning their contact centers to a single network infrastructure from the traditional two-network (voice network and separate data network) model. These benefits include cost savings, remote agent flexibility and application enhancements. The Company has developed a set of tools and methodologies to help clients financially model, plan, configure, integrate and support Converged Internet Protocol (IP) network solutions within their contact center environments. We also generate Managed services revenue from this Service Line by providing contact center support and monitoring services to clients.

Traditional CRM Service Line

The Company s traditional CRM Service Line focuses on operational consulting and integrating or building a system for the client. We also generate Managed services revenue from this Service Line by providing remote application support to clients.

Types of Revenue

Managed services, Consulting services, and the resale of Product are frequently sold and delivered together. Many Consulting services engagements for the design and implementation of customer service or marketing solutions lead to the sale of one of our Managed services, which may also include a long-term maintenance and support or hosting relationship, and the sale of Product.

Managed Services

Growth in Managed services revenue is primarily driven by the sale of Behavioral Analytics Service and Integrated Contact Solutions engagements. These Managed services are described below:

The Behavioral Analytics Service includes the deployment and ongoing operation of our proprietary Behavioral Analytics System. Based on each client s business requirements, the applications are configured and integrated into the client s environment and then deployed in either a remote-hosted or, in some cases, an on-premise hosted environment. The Behavioral Analytics Service is provided on a subscription basis and the contract duration generally is three to five years. The fees and costs related to the initial deployment are deferred and amortized over the life of the contract.

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Contact Center Managed Services include monitoring and support related to complex IP and traditional contact center voice architectures. These services include routine maintenance and technology upgrades and the resolution of highly complex issues that involve multiple technology components and vendors. Our support and monitoring services reduce the cost and impact of contact center downtime for our clients and anticipate problems before they occur.

In addition, we also generate Managed services revenue from two other sources. Marketing Managed Services revenue is generated from hosted customer and campaign data management and mass email fulfillment services. We also continue to provide remote call center application support and maintenance services to a small number of long-term clients. These two sources of Managed services revenue are likely to diminish over time as we focus on growth through the Behavioral Analytics Service and Integrated Contact Solutions Service Lines.

Consulting Services

In addition to the Consulting services revenue generated by Behavioral Analytics Service and Integrated Contact Solutions engagements, we derive a portion of our revenue from a broad range of Traditional CRM consulting and systems integration work with long-standing accounts, as well as newer accounts more recently obtained through our Behavioral Analytics Service and Integrated Contact Solutions Service Lines. Our Consulting services are billed on a time-and-materials basis or on a fixed-fee basis and generally include a combination of the following:

- Evaluating our clients efficiency and effectiveness in handling customer interactions. We observe, measure, and analyze the critical aspects of each customer interaction, including the number of legacy systems used to handle the situation, interaction time, reason for interaction, and actions taken to resolve any customer issues.

- Performing detailed financial analysis to calculate the expected return on investment for the implementation of various CRM solutions. This process helps our clients establish goals, alternatives, and priorities and assigns client accountability throughout resulting projects.

- Designing integrated architectures for enterprise-wide contact center environments. Our architects optimize cost efficiency with reliability, functionality, and effectiveness as we help our clients migrate to state-of-the-art infrastructure.

- Implementing the functional, technical, and human performance aspects of CRM solutions. This often involves the integration of a variety of infrastructure and application hardware and software from third-party vendors.

Product

We also generate revenue from the resale of Product, which consists of software and hardware primarily sold through our Integrated Contact Solutions Service Line. The vast majority of this revenue relates to reselling products from Cisco Systems, Inc.

Business Segments

Beginning in 2008, the Company has operated in two business segments, the Behavioral Analytics Service and Integrated Contact Solutions/CRM, based on the criteria of the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 131 Disclosure about Segments of an Enterprise and Related Information . These segments are consistent with the Company s management of the business and reflect its internal financial reporting structure and operating focus.

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The Behavioral Analytics Service business segment focuses on solutions that improve the reliability of call recording and applies human behavioral modeling to analyze and improve customer interactions. The Behavioral Analytics Service is primarily a hosted solution and is delivered as a managed subscription service. Revenue generated from Behavioral Analytics Service assessments, deployments, and subscription services, as well as marketing application hosting and email fulfillment services, are included in this business segment s financial results.

The Integrated Contact Solutions/CRM business segment focuses on helping clients realize the benefits of transitioning their contact centers to a single network infrastructure from the traditional two-network (voice network and separate data network) model. Revenue generated from Consulting services, Managed services, Product resale, traditional CRM and remote application support services are included in this business segment s financial results.

Management believes that Segment Operating Income/(Loss) Before Stock-Based Compensation, Severance and Related Costs, and Depreciation and Amortization is an appropriate measure of evaluating the operational performance of the Company s segments. However, this measure should be considered in addition to, not as a substitute for, or superior to, income from operations or other measures of financial performance prepared in accordance with General Accepted Accounting Principles. The Company does not allocate depreciation or amortization or other items below the Operating Income/(Loss) level to the business segments. Also, the Company does not track or review asset information, other than capital expenditures, by reportable segments. See Note Seventeen Segments of the Notes to Consolidated Financial Statements included in Part II Item 8 of this Annual Report on Form 10-K for the revenue and net (loss)/income of each of our business segments for the fiscal year ended 2008. Prior to 2008, the Company operated in one business segment and did not record financial information for the two current business segments. Financial information for the two current business segments for the fiscal year ended 2007 is not presented because it would be impractical to obtain this information.

International Operations

The Company s services are delivered to clients in North America (U.S. and Canada), Europe, and Australia. The Company s long-lived assets are and have been predominately located in North America and consist of equipment, software, furniture, and fixtures and leasehold improvements (net of accumulated depreciation). Net revenue for the Company s international operations (Europe and Australia) was $2.5 million, $2.7 million and $4.1 million for the fiscal years ended 2008, 2007, and 2006, respectively.

Methods of Distribution

A substantial majority of our Consulting services, Managed services and Product are provided to our clients through direct contractual relationships. Approximately 8% of our revenue in 2008 was generated from ongoing relationships with other companies, through which we make our services and third-party products available to the clients of such companies.

Intellectual Property Rights

We view as proprietary the intellectual property that underlies our work product resulting from our services for clients, including the intellectual property rights to any custom software developed in the course of an engagement. We protect our intellectual property rights with patents, copyrights, and trademarks, applicable trade secret laws, and contractual restrictions on disclosure, licensing, and transferring title. In addition, we rely upon a combination of trade secret and common law, employee nondisclosure policies, and third-party confidentiality agreements to protect our intellectual property rights.

A majority of our clients require that we grant to them some or all proprietary and intellectual property rights with respect to the original work product resulting from our services, including the intellectual property rights to any custom software developed for them. Absent agreement to the contrary, each grant of proprietary and intellectual property rights limits our ability to reuse work product components with other clients. As a result, it is our practice to retain the rights in the underlying core intellectual property on which it is based, including methodologies, workplans, and software. Further, it is our policy to obtain from our clients a license to permit us to market custom software and other original materials to other clients. These arrangements may be nonexclusive or exclusive, and licensors to us may retain the right to sell products and services that compete with those of the Company.

Seasonality

We typically experience declines in revenue and earnings in the fourth quarter, as the total number of billable hours and days on Consulting services engagements are reduced due to holidays and vacations.

Clients

During fiscal year 2008, our 5 and 20 largest clients accounted for 37% and 70% of our total revenue, respectively. Our largest client in 2008 United HealthCare Services, Inc., accounted for 17% of our 2008 total revenue. For fiscal year 2008, 24 clients each accounted for over $1 million of total revenue. Our focus is on developing long-term relationships with our clients, but our activities with specific clients may fluctuate periodically, as individual Consulting services projects are initiated and progress through their lifecycle. As a result, the percentage of total revenue contributed by any particular client can be expected to vary, perhaps significantly, among periods. See Note Two Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements included in Part II Item 8 of this Annual Report on Form 10-K (this Form 10-K).

Competition

We operate in a highly competitive and rapidly changing market and compete with a variety of organizations that offer services similar to ours. The market includes a variety of participants that compete with us at various levels of our business, including strategic consulting firms, systems integrators, web-consulting firms, software vendors, voice recording and voice analytic service providers, online agencies, and firms that provide both consulting and systems integration services, including certain of our vendors. In our opinion, few competitors offer the full range and depth of CRM services that we can provide, but they may compete with us on individual factors such as expertise, price, or capacity.

Many of our competitors have longer operating histories, more clients, longer relationships with their clients, greater brand or name recognition, and significantly greater financial, technical, marketing, and public relations resources than we do. As a result, our competitors may be in a better position to respond quickly to new or emerging technologies and changes in client requirements. They may also develop and promote their products and services more effectively than we do. New market entrants also pose a threat to our business. Existing or future competitors may develop or offer solutions that are comparable or superior to ours at a lower price.

Environmental Issues

There are no known material compliance issues with any federal, state, or local environmental regulations.

Employees

As of December 27, 2008, we employed 421 persons, none of whom is represented by a union.

Available Information and Other

Our principal internet address is www.eloyalty.com. Our Annual, Quarterly, and Current Reports on Forms 10-K, 10-Q, and 8-K, and any amendments thereto, as well as the Forms 3, 4, and 5 beneficial ownership reports filed with respect to our stock, are made available free of charge on our website as soon as reasonably practicable after such material is filed with, or furnished to, the Securities and Exchange Commission (SEC). However, the information found on our website is not part of this or any other report filed by us with the SEC.

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eLoyalty was incorporated in Delaware in May 1999. Our executive office is located at 150 Field Drive, Suite 250, Lake Forest, Illinois 60045. Our telephone number is (847) 582-7000.

Item 1A. ***Risk Factors.***

There is a range of risks and uncertainties that could adversely affect our business and our overall financial performance. In addition to the matters discussed elsewhere in this Form 10-K, we believe the more significant of such risks and uncertainties include the following:

We have not realized a profit in nine years and there is no guarantee that we will realize a profit in the foreseeable future.

As of December 27, 2008, we had an accumulated deficit of $180.2 million. We incurred net losses available to common stockholders of $22.9 million in 2008, $20.1 million in 2007 and $12.6 million in 2006, and may continue to incur net losses in the future.

Our financial results could be adversely affected by economic and political conditions and the effects of these conditions on our clients businesses and levels of business activity.

Global economic and political conditions affect our clients businesses and the markets they serve. A severe and/or prolonged economic downturn or a negative or uncertain political climate could adversely affect our clients financial condition and the levels of business activity of our clients and the industries we serve. This may reduce demand for our services or depress pricing of those services and have a material adverse effect on our results of operations. Changes in global economic conditions could also shift demand to services for which we do not have competitive advantages, and this could negatively affect the amount of business that we are able to obtain. In addition, these economic conditions may cause our clients to delay payments for services we have provided to them resulting in a negative impact to our cash flow. If we are unable to successfully anticipate changing economic and political conditions, we may be unable to effectively plan for and respond to those changes, and our business could be negatively affected.

Our financial results are subject to significant fluctuations because of many factors, any of which could adversely affect our stock price.

It is possible that in some future periods our operating results may be below the expectations of public market analysts and investors. In this event, the price of our common stock may fall. Our revenue and operating results may vary significantly due to a number of factors, many of which are not in our control. We may incur an impairment of goodwill if our financial results are adversely impacted by these factors and we continue to incur losses or our stock price declines. These factors include:

- Unanticipated cancellations or deferrals of, or reductions in the scope of, major engagements;
- Our ability to deliver complex projects and to provide scalable and reliable solutions hosting;
- The number, size, and scope of our projects;
- Our client retention and acquisition rate and satisfaction with our services and solutions;
- The length of the sales cycle associated with our solutions;
- The sale of product;

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- The efficiency with which we utilize our employees;
- How we plan and manage our existing and new engagements;
- Our ability to manage future growth, including the growth of the Behavioral Analytics Service;
- Changes in pricing policies by us or our competitors;
- Number of billing days; and
- Availability of qualified employees.

We depend on a limited number of clients for a significant portion of our revenue, and the loss of a significant customer or a substantial decline in the number or scope of projects that we do for a significant customer could have a material adverse effect on our businesses.

We derive and expect to continue to derive for the foreseeable future a significant portion of our total revenue from a limited number of clients. See Business and Clients in Part I Item 1 and Year Ended December 27, 2008 Compared with the Year Ended December 29, 2007 included in Management s Discussion and Analysis of Financial Condition and Results of Operations in Part II Item 7 of this Form 10-K. With the exception of our subscription clients for the Behavioral Analytics Service, the volume of services that we provide for a specific client is likely to vary from year to year, and a major client in one year might not use our services in a subsequent year. To the extent that any significant client uses less of our services or terminates its relationship with us, as may occur as clients respond to conditions affecting their own business, our total revenue could decline substantially and that could seriously harm our business.

We depend on good relations with our major clients, and any harm to these good relations may materially and adversely harm our business or our ability to compete effectively.

To attract and retain clients, we depend to a large extent on our relationships with our clients and our reputation for high quality consulting services and managed services. We design, create, implement, host, maintain, and support applications and solutions that are often critical to our clients businesses. We believe that we generally enjoy good relations with our clients. If a client is not satisfied with our services, products, or solutions, including those of subcontractors that we may employ, it may be damaging to our reputation and business. Any defects or errors in our services or solutions or failure to meet our clients expectations could result in:

- Delayed or lost revenue due to adverse client reaction;
- Requirements to provide additional services to a client at a reduced fee or at no charge;
- Negative publicity, which could damage our reputation and adversely affect our ability to attract or retain clients; and
- Claims for damages against us, regardless of our responsibility for such failure.

If we fail to meet our contractual obligations with our clients, we could be subject to legal liabilities or loss of clients. Although our contracts typically include provisions to limit our exposure to legal claims for the services and solutions we provide and the applications and systems we develop or integrate, these provisions may not protect us in all cases.

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If we do not effectively manage the risks associated with increasingly complex client projects and new service offerings, our profit margins and our financial results may suffer.

We may fail to estimate accurately the time and resources necessary for the performance of our services. It can be difficult to judge the time and resources necessary to complete consulting services projects, to deploy, support, and operate hosted solutions, to support and maintain complex contact center architectures and/or to anticipate the amount of product needed to complete a project. A number of different risks must be accounted for, including, but not limited to, the variability and predictability of the number, size, scope, cost, and duration of and revenue from client engagements, unanticipated cancellations, or deferrals of client contracts or follow-on phases of engagements in process, collection of revenue, variable employee utilization rates, project personnel costs, and engagement requirements. Accurate estimates as to the costs and timing of completion of engagements is particularly important for the contracts that are performed on a fixed-price or not-to-exceed basis. Our failure to estimate accurately these risks could reduce the profitability of, or result in a loss on, our engagements and could damage our client relationships and our reputation.

Our industry is very competitive and, if we fail to compete successfully, our market share and business will be adversely affected.

We operate in a highly competitive and rapidly changing market and compete with a variety of organizations that offer services similar to those we offer. The market includes a variety of participants that compete with us at various levels of our business, including strategic consulting firms, systems integrators, general information technology services providers, web consulting firms, voice recording and voice analytic service providers, application service providers, and other firms that provide both consulting and systems integration services and solutions. New market entrants also pose a threat to our business.

Many of our competitors have longer operating histories, more clients, and longer relationships with their clients, greater brand or name recognition and significantly greater financial, technical, marketing, and public relations resources than we do. As a result, our competitors may have enhanced abilities to compete for specific clients and market share generally, including through substantial economic incentives to clients to secure contracts. Existing or future competitors may develop or offer solutions that are comparable or superior to ours at a lower price. In addition, our competitors may be in a better position to respond quickly to new or emerging technologies and changes in client requirements or expectations. They may also develop and promote their products and services more effectively than we do and be better able to compete for skilled professionals by offering substantial compensation incentives.

We rely heavily on our senior management team for the success of our business.

Given the highly specialized nature of our services, senior management must have a thorough understanding of our service offerings as well as the skills and experience necessary to manage the organization. If one or more members of our senior management team leaves and we cannot replace them with a suitable candidate quickly, we could experience difficulty in managing our business properly, and this could harm our business prospects, client relationships, employee morale, and results of operations.

Our ability to recruit talented professionals and retain our existing professionals is critical to the success of our business.

We believe that our success will depend substantially on our ability to attract, train, motivate, and retain highly skilled management, strategic, technical, product development, and other key professional employees. The information-technology services industry continues to be people-intensive and faces a shortage of qualified personnel, especially those with specialized skills or experience. We compete with other companies to recruit and hire from this limited pool. If we cannot hire and retain qualified personnel, or if a significant number of our current employees leave, we may be unable to complete or retain existing engagements or bid for new engagements of similar scope and revenue.

If one or more of our key personnel were unable or unwilling to continue in their present positions, they could be difficult to replace and our business could be seriously harmed. This would result not only in the loss of key employees, but also potentially in the loss of client relationships or new business opportunities. In addition, there is no guarantee that the employee and customer non-solicitation and non-competition agreements we have entered into with our senior professionals would deter them from departing us for our competitors or that such agreements would be upheld and enforced by a court or other arbiter across all jurisdictions where we engage in business.

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We must keep pace with the rapid rate of technological innovation and change, as well as evolving industry standards, in order to build our business.

Our industry is characterized by rapid and continually changing technologies, the introduction of many new products and services and evolving industry standards and client preferences. Our solutions must meet the requirements of and achieve significant acceptance among our current and prospective clients within this environment. Our future business will depend on our continuing ability to adapt to and incorporate changing technologies and emerging industry standards and to remain knowledgeable with respect to emerging CRM technology, customer loyalty research, and applied CRM solutions.

In addition, our future business depends upon continued growth in the acceptance and use of the Behavioral Analytics Service by our current and prospective clients and their customers and suppliers. Their acceptance and usage in turn may depend upon factors such as: the actual or perceived benefits of adoption and implementation of Behavioral Analytics Service and other CRM methodologies and technologies, including the predictability of a meaningful return on investment, cost efficiencies or other measurable economic benefits; their actual or perceived reliability, scalability, ease of use, and access to such new technologies and methodologies; and their willingness to adopt new business methods incorporating a customer-centric approach.

We cannot assure that we will be successful in anticipating or responding to these developments and challenges on a timely or competitive basis or at all, or that our ideas and solutions will be successful in the marketplace. In addition, new or disruptive technologies and methodologies by our competitors may make our service or solution offerings uncompetitive. Any of these circumstances could adversely affect our ability to obtain and successfully complete substantial new client engagements that are important to maintain and grow our business. The continued growth of and intensifying competition within the CRM market may increase these challenges.

We depend on our ability to rapidly learn, use, and integrate software and other technology developed by third parties to successfully compete in the CRM market, and our ability to maintain and grow our business may be affected by our ability to maintain strong relationships with CRM software providers and other alliance partners.

To provide certain of our solutions and services, we rely on third-party software, telephony, and other infrastructure and related services. If we are unable to integrate these components in a fully functional manner, we may experience difficulties that could delay or prevent the successful development, introduction, or marketing of new solutions. We could also incur substantial costs if we need to modify our services or infrastructure to adapt to changes in these third-party products and services.

We have invested time and resources in seeking to maintain strong relationships with applicable software and technology providers and we plan to make additional investments in the future. The benefits we anticipate from these relationships play an important role in our future growth strategies. We rely on these relationships with third-party vendors and alliance partners to allow us to learn rapidly about their existing and next generation technologies, to develop appropriate methods to integrate their products and services into our solutions and to obtain joint sponsorship of solution offerings. If we are unable to initiate and successfully maintain these relationships, we may fail to obtain the future benefits we hope to derive from them and significantly reduce our ability to successfully create and deploy new solution offerings incorporating their technologies. In addition, we may be adversely affected by the failure of one or more of our vendors or alliance partners, which could lead to reduced marketing exposure, fewer sales leads or joint marketing opportunities, and a diminished ability to gain access to or develop leading-edge solutions. As our most important alliance relationships are non-exclusive, our alliance partners are also free to establish similar or preferred relationships with our competitors. These circumstances could adversely impact the success of our growth strategies that, in turn, could adversely affect our results of operations.

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If growth in the use of CRM technologies declines, demand for our services may decrease.

CRM application and infrastructure technologies are central to many of our solutions. Our business depends upon continued growth in the use of these technologies by our clients, prospective clients, and their customers and suppliers. If the number of users of this technology does not increase and commerce using this technology does not become more accepted and widespread, demand for our services may decrease. Factors that may affect the usage of this technology include:

- Actual or perceived lack of security of information;
- Lack of access and ease of use;
- Congestion of Internet traffic or other usage delays;
- Inconsistent quality of service;
- Uncertainty regarding intellectual property ownership;
- Reluctance to adopt new business methods; and
- Costs associated with the obsolescence of existing infrastructure.

It may be difficult for us to access debt or equity markets to meet our financial needs.

If, for any reason, we need to raise additional funds in the future, through public or private debt or equity financings, such funds may not be available or may not be available on terms favorable to us.

We have a limited ability to protect our intellectual property rights, which are important to our success and competitive position.

Our ability to protect our software, methodologies, and other intellectual property is important to our success and our competitive position. We regard our intellectual property rights as proprietary and attempt to protect them with patents, copyrights, trademarks, trade secret laws, confidentiality agreements, and other methods. Despite our efforts to protect our intellectual property rights from unauthorized use or disclosure, parties may attempt to disclose, obtain, or use our rights. The steps we take may not be adequate to prevent or deter infringement or other misappropriation of our intellectual property rights. In addition, we may not detect unauthorized use of, or take timely and effective actions to enforce and protect, our intellectual property rights. Existing laws of some countries in which we provide services or solutions afford more limited protection of intellectual property rights than laws in the United States.

We may be required to obtain licenses from others to refine, develop, market, and deliver current and new services and solutions. There can be no assurance that we will be able to obtain any of these licenses on commercially reasonable terms or at all, or that rights granted by these licenses ultimately will be valid and enforceable.

Others could claim that our services, software or solutions infringe upon their intellectual property rights or violate contractual protections.

We believe that our services, software, and solutions do not infringe upon the intellectual property rights of others. However, we or our clients may be subject to claims that our services, products, or solutions, or the products of others that we offer to our clients, infringe upon the intellectual property rights of others. Any infringement claims may result in substantial costs, divert management attention and other resources, harm our reputation, and prevent us from offering some services, software, or solutions. A successful infringement claim against us could materially and adversely affect our business.

In our contracts, we generally agree to indemnify our clients for expenses and liabilities resulting from claimed infringement by our services, software, or solutions, excluding third-party components, of the intellectual property rights of others. In some instances, the amount of these indemnities may be greater than the revenue we receive from the client. In addition, our business includes the development of customized software modules in connection with specific client engagements, particularly in our systems integration business. We often assign to clients the copyright and, at times, other intellectual property rights in and to some aspects of the software and documentation developed for these clients in these engagements. Although our contracts with our clients generally provide that we also retain rights to our intellectual property, it is possible that clients may assert rights to, and seek to limit our ability to resell or reuse, this intellectual property.

Increasing government regulation could cause us to lose clients or impair our business.

We are subject not only to regulations applicable to businesses generally, but we, and the solutions we offer to our clients, also may be subject to United States and foreign laws and regulations directly applicable to electronic commerce, the Internet, and data privacy and security. Laws and regulations in the United States, as well as legislative initiatives that may be considered in the future, may increase regulation of the Internet and impose additional restrictions relating to the privacy and security of personal data. We may be affected indirectly by any such legislation to the extent that it decreases acceptance or growth of the Internet or otherwise impacts our existing and prospective clients. Any such laws and regulations therefore could affect our existing business relationships or prevent us from getting new clients.

The unauthorized disclosure of the confidential client data that we maintain could result in a significant loss of business to eLoyalty and subject us to substantial liability.

In the course of implementing our Behavioral Analytics Service, we record and analyze clients telephone calls. These calls contain numerous references to highly sensitive confidential data of the customers of our clients, many of which are required to comply with federal and state laws concerning privacy and security. In addition, we have made certain contractual commitments to our clients regarding this confidential data.

We take extensive precautions to prevent the unauthorized disclosure or loss of such data and to protect the Company through technical and contractual means. Nonetheless, the disclosure or loss of such data could result in the considerable diminution of our business and prospects and could subject us to substantial liability.

In addition, the laws and regulations and industry standards governing these matters are currently changing rapidly. It is possible that the resources we devote to comply with such laws and regulations, industry standards, and our clients particular requirements could increase materially. In our contracts, we generally agree to indemnify our clients for expenses and liabilities resulting from unauthorized disclosure of confidential data. In some instances, the amount of these indemnities may be greater than the revenue we receive from the client.

We must maintain our reputation and expand our name recognition to remain competitive.

We believe that establishing and maintaining a good reputation and brand name is critical for attracting and expanding our targeted client base. If our reputation is damaged or if potential clients do not know what solutions we provide, we may become less competitive or lose our market share. Promotion and enhancement of our name will depend largely on our success in providing high quality services, software, and solutions, which cannot be assured. If clients do not perceive our solutions to be effective or of higher quality, then our brand name and reputation could be materially and adversely affected.

Our clients use our solutions for critical applications. Any errors, defects, or other performance problems, including those in our proprietary software or products supplied by third-party vendors, could result in financial or other damages. In addition to any liability we might have, performance problems could also adversely affect our brand name and reputation.

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Item 1B. ***Unresolved Staff Comments.***

As of March 11, 2009, we have no unresolved comments from the SEC.

Item 2. ***Properties.***

Our principal physical properties employed in our business consist of our leased office facilities in Chicago and Lake Forest, Illinois; Edina, Minnesota; and Austin, Texas. Both of our business segments use the Lake Forest, Illinois and Austin, Texas facilities in their operations. The Edina, Minnesota and Chicago, Illinois facilities are primarily used by our Behavioral Analytics Service segment. Our executive offices are located at the Lake Forest, Illinois facility.

Our total employable space is approximately 46,000 square feet. We do not own any real estate and believe that our leased facilities are appropriate for our current and anticipated business requirements.

Item 3. ***Legal Proceedings.***

The Company, from time to time, has been subject to legal claims arising in connection with its business. While the results of these claims cannot be predicted with certainty, there are no asserted claims against the Company that, in the opinion of management, if adversely decided, would have a material effect on the Company s financial position, results of operations or cash flows.

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

No matters were submitted to a vote of security holders, through the solicitation of proxies or otherwise, during the fourth quarter of our fiscal year 2008.

PART II.

Item 5. ***Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.***

Our Common Stock, par value $0.01 per share, is traded on the NASDAQ Global Market under the symbol ELOY. The following table sets forth, for the periods indicated, the quarterly high and low sales prices of the common stock on the NASDAQ Global Market.

	High	Low
Fiscal Year 2008		
Fourth Quarter	$ 5.00	$ 1.77
Third Quarter	6.86	4.06
Second Quarter	10.86	4.80
First Quarter	13.62	7.41
Fiscal Year 2007		
Fourth Quarter	$ 16.33	$ 9.60
Third Quarter	22.68	11.81
Second Quarter	25.84	18.99
First Quarter	23.49	17.95

There were approximately 114 owners of record of our Common Stock as of March 2, 2009.

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Stock Performance Graph

The following graph compares the cumulative total stockholder return on eLoyalty Common Stock with the cumulative total return of (i) the NASDAQ Global Market Index, and (ii) a peer group of other publicly traded information technology consulting companies selected by the Company (the Peer Group Index). Cumulative total stockholder return is based on the period from December 26, 2003 through the Company s fiscal year end on Saturday, December 27, 2008. The comparison assumes that $100 was invested on December 26, 2003 in each of eLoyalty Common Stock, the NASDAQ Global Market Index and the Peer Group Index, and that any and all dividends were reinvested.

Comparative Cumulative Total Return

For eLoyalty Corporation,

NASDAQ Global Market Index, Peer Group Index and Previous Peer Group Index

	12/26/03	12/31/04	12/30/05	12/29/06	12/28/07	12/26/08
eLoyalty Corporation	$ 100.00	$ 156.80	$ 274.40	$ 500.00	$ 335.47	$ 77.33
Peer Group Index (1)	100.00	105.87	95.93	125.96	104.52	57.86
NASDAQ Global Market Index	100.00	108.41	110.79	122.16	134.29	79.25
Previous Peer Group Index (2)	100.00	138.74	96.37	103.76	129.84	66.47

(1) The Peer Group Index consists of The Hackett Group, Diamond Management & Technology Consultants, Sapient Corporation, Convergys Corporation, Perot Systems Corporation, and Verint Systems, Inc. Our Peer Group in fiscal year 2008 was expanded to include three managed service companies, Convergys Corporation, Perot Systems Corporation and Verint Systems, Inc., which were not a part of our Previous Peer Group. The Peer Group was changed to reflect the increased managed services component of our business.

(2) The previous Peer Group Index consisted of The Hackett Group, Diamond Management & Technology Consultants and Sapient Corporation.

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Repurchase of Equity Securities

The following table provides information relating to the Company s purchase of shares of its common stock in the fourth quarter of 2008. All of these purchases reflect shares withheld upon vesting of restricted stock or installment stock to satisfy tax-withholding obligations.

Period	Total Number of Shares Purchased	Average Price Paid Per Share
September 28, 2008 October 28, 2008	21,601	$ 3.81
October 29, 2008 November 28, 2008	118,493	$ 3.23
November 29, 2008 December 27, 2008	68,981	$ 2.22
Total	209,075	$ 2.96

See Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters included in Part II Item 12 of this Form 10-K for more information about securities authorized for issuance under our various compensation plans.

Dividends

Historically, we have not paid cash dividends on our common stock, and we do not expect to do so in the future. However, cash dividends of $1.3 million were paid in 2008 on the Company s Series B convertible preferred stock (the Series B stock), which accrues dividends at the rate of 7% per year and which were payable semi-annually in January and July. In order to conserve cash given the current macro-economic uncertainties, beginning January 1, 2009, we suspended the semi-annual cash dividend on our Series B stock (the amount of this semi-annual dividend is approximately $0.6 million). Under the terms of the Preferred Stock agreement, unpaid dividends are cumulative and accrue at the rate of 7% per annum. Payment of future dividends on the Preferred Stock will be determined by the Company s Board of Directors based on the Company s outlook and macro-economic conditions. The amount of each dividend accrual would decrease by any conversions of the Series B stock into common stock, as Series B conversions require us to pay accrued but unpaid dividends at the time of conversion. Conversions of Series B stock became permissible at the option of the holder after June 19, 2002. See Item 7 of Part I, Liquidity and Capital Resources for a further discussion.

Item 6. ***Selected Financial Data.***

The following tables summarize our selected financial data. This information should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations, and the Consolidated Financial Statements of the Company and notes thereto, which are included elsewhere in this Form 10-K. The statements of operations data for the fiscal years ended 2008, 2007, 2006, 2005, and 2004 and the balance sheet data as of December 27, 2008, December 29, 2007, December 30, 2006, December 31, 2005, and January 1, 2005, below, are derived from our audited financial statements. Fiscal year 2004 consisted of fifty-three weeks instead of fifty-two weeks, which did not have a material impact on our financial position or results of operations.

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Consolidated Statements of Operations Data
(In thousands, except share and per share data)

	For the Fiscal Years Ended				
	2008	**2007**	**2006**	**2005**	**2004**
Revenue:					
Services	$ 77,796	$ 88,046	$ 71,980	$ 65,556	$ 65,090
Product	9,777	9,185	13,579	9,710	3,153
Revenue before reimbursed expenses (net revenue)	87,573	97,231	85,559	75,266	68,243
Reimbursed expenses	3,624	4,874	4,269	3,742	4,330
Total revenue	91,197	102,105	89,828	79,008	72,573
Operating Expenses:					
Cost of services(1)(2)	51,613	58,496	58,604	49,477	46,468
Cost of product	7,945	6,993	10,183	7,331	2,434
Cost of revenue before reimbursed expenses	59,558	65,489	68,787	56,808	48,902
Reimbursed expenses	3,624	4,874	4,269	3,742	4,330
Total cost of revenue, exclusive of depreciation and amortization shown below:	63,182	70,363	73,056	60,550	53,232
Selling, general and administrative(1)(2)	43,155	47,075	25,328	20,385	19,482
Severance and related costs(1)	1,635	1,333	737	411	947
Depreciation	3,845	3,186	2,095	5,151	5,247
Amortization of intangibles	340	423	370	532	350
Total operating expenses	112,157	122,380	101,586	87,029	79,258
Operating loss	(20,960)	(20,275)	(11,758)	(8,021)	(6,685)
Interest and other income, net	70	1,484	681	374	231
Loss from continuing operations before income taxes	(20,890)	(18,791)	(11,077)	(7,647)	(6,454)
Income tax (provision) benefit	(15)	53	(71)	17	587
Loss from continuing operations	(20,905)	(18,738)	(11,148)	(7,630)	(5,867)
Loss on liquidation of subsidiary	(748)				
Net loss	(21,653)	(18,738)	(11,148)	(7,630)	(5,867)
Dividends related to Series B stock	(1,296)	(1,405)	(1,464)	(1,471)	(1,499)
Net loss available to common stockholders	$ (22,949)	$ (20,143)	$ (12,612)	$ (9,101)	$ (7,366)
Basic loss from continuing operations per common share	$ (2.02)	$ (2.23)	$ (1.65)	$ (1.20)	$ (0.97)
Basic net loss per common share	$ (2.21)	$ (2.40)	$ (1.86)	$ (1.43)	$ (1.22)
Diluted loss from continuing operations per common share	$ (2.02)	$ (2.23)	$ (1.65)	$ (1.20)	$ (0.97)
Diluted net loss per common share	$ (2.21)	$ (2.40)	$ (1.86)	$ (1.43)	$ (1.22)
(In millions)					
Basic weighted average shares outstanding	10.37	8.40	6.77	6.36	6.03

Diluted weighted average shares outstanding	14.00	12.90	11.70	10.90	10.44

(1) Stock-based compensation, primarily restricted stock, included in individual line items above:

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	(In thousands) For the Fiscal Year Ended				
	2008	2007	2006	2005	2004
Cost of services	$ 3,345	$ 1,004	$ 1,632	$ 1,154	$ 1,063
Selling, general and administrative	11,335	9,444	2,386	1,462	1,697
Severance and related costs	103	196		(25)	176

(2) Beginning in fiscal year 2007, the Company classified $18.3 million of certain expenses, which had been previously reported within Cost of services as Selling, general and administrative expense. For further discussion see Part II Item 7 of this Form 10-K, Year Ended December 29, 2007 Compared with the Year Ended December 30, 2006 .

	Consolidated Balance Sheet Data (In thousands) As of				
	December 27, 2008	December 29, 2007	December 30, 2006	December 31, 2005	January 1, 2005
Total cash(1)	$ 30,719	$ 23,867	$ 31,928	$ 18,375	$ 20,793
Short-term investments(2)	$ 108	$ 451	$	$ 4,000	$ 6,975
Working capital(3)	$ 24,688	$ 20,621	$ 32,640	$ 25,341	$ 28,565
Total assets	$ 64,223	$ 60,051	$ 64,568	$ 45,228	$ 55,367
Long-term obligations	$ 7,846	$ 9,041	$ 5,471	$ 1,145	$ 1,438
Redeemable preferred stock	$ 18,460	$ 19,100	$ 20,902	$ 20,910	$ 21,169
Stockholders equity	$ 12,847	$ 7,803	$ 18,614	$ 11,475	$ 18,963

(1) Total cash consists of cash and cash equivalents of $27.1 million, $21.4 million, $31.6 million, $17.9 million, and $20.1 million and restricted cash of $3.7 million, $2.5 million, $0.3 million, $0.5 million, and $0.7 million as of December 27, 2008, December 29, 2007, December 30, 2006, December 31, 2005, and January 1, 2005, respectively.

(2) Prior to 2006, short-term investments reflected above were auction rate securities. In 2008 and 2007, included in other current assets are $0.1 million and $0.5 million of investments, which represent the market value of equity securities in an unrelated publicly traded company.

(3) Represents total current assets less total current liabilities.

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations.***

Critical Accounting Policies and Estimates

Our management s discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue, and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to the costs and timing of completion of client projects, our ability to collect accounts receivable, the timing and amounts of expected payments associated with cost reduction activities, the ability to realize our net deferred tax assets, contingencies, and litigation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

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We believe the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our consolidated financial statements.

Revenue Recognition

Behavioral Analytics Service Business Unit

Behavioral Analytics Service Line

Consulting services revenue included in the Behavioral Analytics Service Line primarily consists of fees charged to our clients to perform Behavioral Analytics assessments. These assessments are generally performed for our clients on a fixed fee basis. Revenue is recognized as the services are performed with performance generally assessed on the ratio of actual hours incurred to date compared to the total estimated hours over the entire contract.

Managed services revenue included in the Behavioral Analytics Service Line consists of planning, deployment, training and subscription fees. Planning, deployment, and training fees, which are considered to be installation fees related to long-term subscription contracts, are deferred until an installation is complete and are then recognized over the term of the applicable subscription contract. The terms of these subscription contracts generally range from three to five years. As of December 27, 2008 and December 29, 2007, deferred revenue totaled $6.4 million and $5.4 million, respectively. Installation costs incurred are deferred up to an amount not to exceed the amount of deferred installation revenue and additional amounts that are recoverable based on the contractual arrangement. Such costs are amortized over the term of the subscription contract. Costs in excess of the foregoing revenue amount are expensed in the period incurred. As of December 27, 2008 and December 29, 2007, the Company had deferred costs totaling $4.9 million and $3.5 million, respectively.

The amount of revenue generated from Behavioral Analytics Service subscription fees is based on a number of factors, such as the number of agents accessing the system and/or hours of calls analyzed during the specific month. This revenue is recognized as the service is performed for the client.

Marketing Managed Services

Marketing Managed Services revenue is derived from marketing application hosting and email fulfillment. Revenue related to hosting services is generally in the form of a fixed monthly fee received from our clients and is recognized as the services are performed for the client. Any related setup fee would be recognized over the contract period of the hosting arrangement. Revenue related to email fulfillment services is recognized as the services are provided to the client based on the number of emails distributed for the client.

Integrated Contact Solution/CRM Business Unit

Integrated Contact Solutions Service Line

Consulting services revenue included in the Integrated Contact Solutions Service Line consists of the modeling, planning, configuring, or integrating of an IP network solution within our clients contact center environment. These services are provided to the client on a time-and-materials or fixed fee basis. For the integration of a system, the Company recognizes revenue as the services are performed with performance generally assessed on the ratio of hours incurred to date compared to the total estimated hours over the entire contract. For all other consulting services, we recognize revenue as the services are performed for the client.

Managed services revenue included in the Integrated Contact Solutions Service Line consists of fees generated from our contact center support and monitoring services. Support and monitoring fees are generally contracted for a fixed fee, and the revenue is recognized ratably over the term of the contract. Support fees that are contracted on a time and materials basis are recognized as the services are performed for the client.

For fixed price Managed services contracts where the Company provides support for third-party software and hardware, revenue is recorded at the gross amount of the sale because the contracts satisfy the requirements for gross reporting under Emerging Issues Task Force (EITF) 99-19 Reporting Revenue Gross as a Principal versus Net as an Agent . If the contract does not meet the requirements for gross reporting under EITF 99-19, Managed services revenue is recorded at the net amount of the sale.

Revenue from the sale of Product, which is generated primarily from the resale of third-party software and hardware by the Company, is generally recorded at the gross amount of the sale because the contracts satisfy the requirements for Gross reporting under EITF 99-19. Software revenue is recognized in accordance with Statement of Position (SOP) 97-2 Software Revenue Recognition .

Within the Integrated Contact Solutions Service Line, Consulting services, Managed services and the resale of Product may be sold and delivered together. In arrangements that include the resale of software, SOP 97-2 requires determination of vendor specific objective evidence (VSOE) for each of the individual elements. If VSOE does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement is deferred until all elements of the arrangement without VSOE have been delivered to the client. If the remaining undelivered elements are post contract support (PCS) or other deliverables with similar attribution periods, the arrangement revenue is recognized ratably over the remaining service period. Revenue of $0.4 million and $1.5 million has been deferred as of December 27, 2008 and December 29, 2007, respectively, due to the lack of VSOE for elements within these arrangements. This revenue will be recognized when the elements without VSOE are delivered to the client or will be recognized ratably over the remaining service period.

Traditional CRM Service Line

Consulting services revenue included in the Company s traditional Customer Relationship Management (CRM) Service Line consists of fees generated from our operational consulting and integrating or from building a system for our clients. These services are provided to our clients on a time-and-materials or fixed fee basis. For the integration or building of a system, the Company recognizes revenue as the services are performed with performance generally assessed on the ratio of hours incurred to date compared to the total estimated hours over the entire contract. For all other consulting services, we recognize revenue as the services are performed for the client.

Managed services revenue included in the traditional CRM Service Line consists of fees generated from our remote application support. Contracts for remote application support can be based on a fixed fee or time and materials basis. Revenue is recognized ratably over the contract period for fixed fee support. Revenue is recognized as the services are provided to the client for time and material contracts.

In accordance with EITF 00-21 Revenue Arrangements with Multiple Elements, arrangements containing multiple services are segmented into separate elements when the services represent separate earning processes. Revenue related to contracts with multiple elements is allocated based on the fair value of the element and is recognized in accordance with our accounting principles for each element, as described above. If the fair value for each element cannot be established, revenue is deferred until all elements have been delivered to the client. If PCS or similar services are the only remaining activity without established fair value, the revenue is recognized ratably over the service period. Each of our Service Lines may have arrangements that could be reviewed in accordance with EITF 00-21.

Reimbursed expenses revenue includes billable costs related to travel and other out-of-pocket expenses incurred while performing services for our clients. The charge for third-party product and support may be included within this category if the transaction does not satisfy the requirements for gross reporting under EITF 99-19 and the net revenue is recognized as Product or Managed services revenue. An equivalent amount of reimbursable expenses is included in Cost of revenue.

Payments received for Managed services contracts, in excess of the amount of revenue recognized for these contracts, are recorded as Unearned revenue until revenue recognition criteria are met.

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If the Company estimates indicate that a contract loss will occur, a loss provision is recorded in the period in which the loss first becomes probable and can be reasonably estimated.

The Company maintains allowances for doubtful accounts for estimated losses resulting from clients not paying for unpaid or disputed invoices for contractual services provided. Additional allowances may be required if the financial condition of our clients deteriorates.

Stock-Based Compensation

We adopted the provisions of SFAS No. 123R, Share-Based Payment, beginning January 1, 2006, using the modified prospective method. The adoption of SFAS No. 123R did not have a material impact on our financial position or results of operations. SFAS No. 123R requires entities to recognize compensation expense from all share-based payment transactions in the financial statements after the adoption date. SFAS No. 123R establishes fair value as the measurement objective in accounting for share-based payment arrangements and requires all companies to apply a fair-value-based measurement method in accounting for all share-based payment transactions with employees. Historical information is the primary basis for the selection of expected life, expected volatility, expected dividend yield assumptions and anticipated forfeiture rates. The risk-free interest rate is selected based on the yields from U.S. Treasury Strips with a remaining term equal to the expected term of the options being valued. Under the modified prospective method, financial statements for periods prior to the date of adoption are not adjusted for the change in accounting.

Prior to January 1, 2006, we used the intrinsic value method to account for stock-based employee compensation under Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees, and therefore we did not recognize compensation expense in association with options granted at or above the market price of our common stock at the date of grant. See Note Fifteen Stock-Based Compensation of the Notes to Consolidated Financial Statements included in Part II Item 8 of this Form 10-K.

Goodwill

Goodwill is tested annually for impairment in accordance with SFAS No. 142 Goodwill and Other Intangible Assets . The provisions of SFAS 142 require that a two-step test be performed to assess goodwill for impairment. In the first step, the fair value of each reporting unit is compared with its carrying value. If the fair value exceeds the carrying value, goodwill is not impaired and no further testing is performed. The second step is performed if the carrying value exceeds the fair value. The implied fair value of the reporting unit s goodwill must be determined and compared to the carrying value of the goodwill. If the carrying value of a reporting unit s goodwill exceeds its implied fair value, an impairment loss equal to the difference will be recorded.

There has been no impairment identified as a result of the annual review of goodwill as of December 27, 2008 and December 29, 2007. The carrying value of goodwill was $2.6 million as of December 27, 2008 and December 29, 2007. We may incur an impairment of goodwill if our financial results are negatively impacted by current economic conditions and we continue to incur losses or our stock price declines.

Intangible Assets

Intangible assets reflect Marketing Managed Services customer relationships acquired in 2004, the 2003 purchase of a license for certain intellectual property and costs related to patent and trademark applications. These assets are amortized over 12 months to 120 months. The original cost of intangible assets as of December 27, 2008 and December 29, 2007 was $2.7 million and $2.5 million, respectively. Accumulated amortization of intangible assets as of December 27, 2008 and December 29, 2007 were $2.1 million and $1.7 million, respectively. Amortization expense of intangible assets will be $0.2 million for fiscal year 2009 and rounds to zero thereafter.

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Severance and Related Costs

We recorded accruals for severance and related costs associated with our cost reduction efforts undertaken during fiscal years 2001 through 2008. The portion of the accruals relating to employee severance represents contractual severance for identified employees and generally is not subject to a significant revision. In 2008 and in years prior to 2007, a portion of the accruals related to office space reductions, office closures, and associated contractual lease obligations that were based in part on assumptions and estimates of the timing and amount of sublease rentals affected by overall economic and local market conditions. To the extent estimates of the success of our sublease efforts changed, adjustments increasing or decreasing the related accruals have been recognized.

Income Taxes

The Company uses an asset and liability approach, as required under SFAS No. 109, Accounting for Income Taxes, for financial accounting and reporting of income taxes. Deferred income taxes are provided when tax laws and financial accounting standards differ with respect to the amount of income for the year, the basis of assets and liabilities and for tax loss carryforwards. The Company does not provide U.S. deferred income taxes on earnings of U.S. or foreign subsidiaries, which are expected to be indefinitely reinvested.

In July 2006, the FASB issued Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109, Accounting for Income Taxes. The Company adopted the provisions of FIN 48 on December 31, 2006. FIN 48 addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. Significant judgment is used to determine the likelihood of the benefit. FIN 48 also provides guidance on derecognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures.

We have recorded income tax valuation allowances on our net deferred tax assets to account for the unpredictability surrounding the timing of realization of our U.S. and non-U.S. net deferred tax assets due to uncertain economic conditions. The valuation allowances may be reversed at a point in time when management determines realization of these tax assets has become more likely than not, based on a return to predictable levels of profitability.

Other Significant Accounting Policies

For a description of the Company s other significant accounting policies, see Note Two Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements included in Part II Item 8 of this Form 10-K.

Forward-Looking Statements

This Form 10-K contains forward-looking statements that are based on current management expectations, forecasts and assumptions. These include, without limitation, statements containing the words believes, anticipates, estimates, expects, plans, intends, projects, fut could, seeks, target, may, will continue to, predicts, forecasts, potential, guidance, outlook and similar expressions, r strategies, objectives and anticipated future performance and other statements that are not strictly historical in nature. These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or implied by the forward-looking statements. Such risks, uncertainties, and other factors that might cause such a difference include, without limitation, those noted under Risk Factors included in Part I Item 1A of this Form 10-K, as well as the following:

Uncertainties associated with the attraction of new clients, the continuation of existing and new engagements with existing clients and the timing of related client commitments; reliance on a relatively small number of clients for a significant percentage of our revenue;

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Risks involving the variability and predictability of the number, size, scope, cost, duration of, and revenue from client engagements;