ELOYALTY CORP
Form 10-Q
November 04, 2010
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 25, 2010

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	***(I.R.S. Employer***
Incorporation or Organization)	***Identification No.)***

150 Field Drive

Suite 250

Lake Forest, Illinois 60045

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

(847) 582-7000

(Registrant s Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ¨ No ¨

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

The number of shares of the registrant s Common Stock outstanding as of October 28, 2010 was 14,777,101.

Table of Contents

TABLE OF CONTENTS

Table of Contents

Part I. Financial Information

Item 1. Financial Statements

eLoyalty Corporation

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited and in thousands, except share and per share data)

	September 25, 2010	December 26, 2009
ASSETS:		
Current Assets:		
Cash and cash equivalents	$ 14,029	$ 28,982
Restricted cash	3,745	3,745
Receivables (net of allowances of $92 and $151)	10,149	9,313
Prepaid expenses	14,082	10,126
Other current assets	2,166	944
Total current assets	44,171	53,110
Equipment and leasehold improvements, net	5,729	6,194
Goodwill	2,643	2,643
Intangibles, net	430	476
Other long-term assets	11,452	8,180
Total assets	$ 64,425	$ 70,603
LIABILITIES AND STOCKHOLDERS EQUITY:		
Current Liabilities:		
Accounts payable	$ 4,275	$ 3,634
Accrued compensation and related costs	4,468	5,762
Unearned revenue	21,600	20,436
Other current liabilities	4,456	5,067
Total current liabilities	34,799	34,899
Long-term unearned revenue	13,043	9,526
Other long-term liabilities	1,119	1,705
Total liabilities	48,961	46,130
Redeemable Series B Stock, $0.01 par value; 5,000,000 shares authorized and designated; 3,549,160 and 3,616,169 shares issued and outstanding at September 25, 2010 and December 26, 2009, respectively, with a liquidation preference of $19,051 and $19,733 at September 25, 2010 and December 26, 2009, respectively	18,101	18,442
Stockholders Equity:		
Preferred stock, $0.01 par value; 35,000,000 shares authorized; none issued and outstanding		
Common stock, $0.01 par value; 50,000,000 shares authorized; 15,592,431 and 14,871,521 shares issued at September 25, 2010 and December 26, 2009, respectively; and 14,769,819 and 14,220,279 outstanding at September 25, 2010 and December 26, 2009, respectively	156	149

Additional paid-in capital		207,494		203,627
Accumulated deficit		(202,377)		(190,821)
Treasury stock, at cost, 822,612 and 651,242 shares at September 25, 2010 and December 26, 2009, respectively		(4,251)		(3,295)
Accumulated other comprehensive loss		(3,659)		(3,629)
Total stockholders (deficit) equity		(2,637)		6,031
Total liabilities and stockholders equity	$	64,425	$	70,603

See accompanying notes to the Condensed Consolidated Financial Statements.

1

Table of Contents

eLoyalty Corporation

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited and in thousands, except per share data)

	For the Three Months Ended Sept. 25, 2010	For the Three Months Ended Sept. 26, 2009	For the Nine Months Ended Sept. 25, 2010	For the Nine Months Ended Sept. 26, 2009
Revenue:				
Services	$ 18,085	$ 19,688	$ 52,412	$ 59,764
Product	4,188	1,977	10,206	14,847
Revenue before reimbursed expenses (net revenue)	22,273	21,665	62,618	74,611
Reimbursed expenses	1,075	1,033	2,667	2,996
Total revenue	23,348	22,698	65,285	77,607
Operating expenses:				
Cost of services	10,608	13,034	32,266	39,614
Cost of product	3,585	1,353	8,516	12,470
Cost of revenue before reimbursed expenses	14,193	14,387	40,782	52,084
Reimbursed expenses	1,075	1,033	2,667	2,996
Total cost of revenue, exclusive of depreciation and amortization shown below:	15,268	15,420	43,449	55,080
Selling, general and administrative	9,670	8,343	29,063	26,022
Severance and related costs	116	276	936	1,028
Depreciation and amortization	984	1,114	3,134	3,373
Total operating expenses	26,038	25,153	76,582	85,503
Operating loss	(2,690)	(2,455)	(11,297)	(7,896)
Interest and other (expense) income, net	(47)	287	(65)	93
Loss from continuing operations before income taxes	(2,737)	(2,168)	(11,362)	(7,803)
Income tax (provision) benefit	(15)	18	(58)	(16)
Loss from continuing operations	(2,752)	(2,150)	(11,420)	(7,819)
Loss on discontinued operations			(136)	
Net loss	(2,752)	(2,150)	(11,556)	(7,819)
Dividends related to Series B Stock	(316)	(322)	(956)	(969)
Net loss available to common stockholders	$ (3,068)	$ (2,472)	$ (12,512)	$ (8,788)
Per common share:				
Basic loss from continuing operations	$ (0.20)	$ (0.16)	$ (0.84)	$ (0.59)

Basic loss from discontinued operations	$	$	$ (0.01)	$
Basic net loss available to common stockholders	$ (0.22)	$ (0.19)	$ (0.92)	$ (0.66)
Per common share:				
Diluted loss from continuing operations	$ (0.20)	$ (0.16)	$ (0.84)	$ (0.59)
Diluted loss from discontinued operations	$	$	$ (0.01)	$
Diluted net loss available to common stockholders	$ (0.22)	$ (0.19)	$ (0.92)	$ (0.66)
Shares used to calculate basic net loss per share	13,784	13,317	13,644	13,218
Shares used to calculate diluted net loss per share	13,784	13,317	13,644	13,218
Stock-based compensation, primarily restricted stock, is included in individual line items above:				
Cost of services	$ 23	$ 34	$ 95	$ 419
Selling, general and administrative	1,469	1,222	4,338	4,262
Severance and related costs			76	248

See accompanying notes to the Condensed Consolidated Financial Statements.

2

Table of Contents

eLoyalty Corporation

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited and in thousands)

	For the Nine Months Ended Sept. 25, 2010	For the Nine Months Ended Sept. 26, 2009
Cash Flows from Operating Activities:		
Net loss	$ (11,556)	$ (7,819)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization	3,134	3,373
Stock-based compensation	4,433	4,681
Loss on discontinued operations	136	
(Reversal) provision for uncollectible amounts	(79)	10
Severance and related costs	89	248
Changes in assets and liabilities:		
Receivables	(779)	(1,339)
Prepaid expenses	(7,396)	(8,323)
Other assets	(1,220)	(1,456)
Accounts payable	650	(270)
Accrued compensation and related costs	(1,292)	957
Unearned revenue	4,695	17,678
Other liabilities	31	(502)
Net cash (used in) provided by operating activities	(9,154)	7,238
Cash Flows from Investing Activities:		
Capital expenditures and other	(2,425)	(2,987)
Sale of short-term investments		337
Net cash used in investing activities	(2,425)	(2,650)
Cash Flows from Financing Activities:		
Payment of Series B Stock dividends	(1,297)	(648)
Principal payments under capital lease obligations	(1,238)	(994)
Acquisition of treasury stock	(956)	(715)
Increase in restricted cash		(91)
Proceeds from stock compensation and employee stock purchase plans, net	133	112
Net cash used in financing activities	(3,358)	(2,336)
Effect of exchange rate changes on cash and cash equivalents	(16)	81
(Decrease) increase in cash and cash equivalents	(14,953)	2,333
Cash and cash equivalents, beginning of period	28,982	27,064
Cash and cash equivalents, end of period	$ 14,029	$ 29,397

Non-Cash Investing and Financing Transactions:				
Capital lease obligations incurred	$	215	$	865
Capital equipment purchased on credit		215		865
Change in net unrealized security loss				(108)
Supplemental Disclosures of Cash Flow Information:				
Interest paid	$	(125)	$	(293)

See accompanying notes to the Condensed Consolidated Financial Statements.

3

Table of Contents

eLoyalty Corporation

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note One General

In the opinion of management, the accompanying unaudited condensed consolidated financial statements of eLoyalty Corporation (we, eLoyalty, or the Company) include all normal and recurring adjustments necessary for a fair presentation of our condensed consolidated financial position as of September 25, 2010 and December 26, 2009, the condensed consolidated results of our operations for the three months and nine months ended September 25, 2010 and September 26, 2009, and our condensed consolidated cash flows for the nine months ended September 25, 2010 and September 26, 2009, and are in accordance with United States generally accepted accounting principles (GAAP) and in conformity with Securities and Exchange Commission (SEC) Rule 10-01 of Regulation S-X.

The results of operations for any interim period are not necessarily indicative of the results for the full year. The accompanying financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto in our Annual Report on Form 10-K for the fiscal year ended December 26, 2009.

Note Two Summary of Significant Accounting Policies

Certain data center expenses that have been previously reported as Selling, general and administrative have been reclassified as Cost of services within our Behavioral Analytics Service Business Unit. We believe this revised classification will provide a clearer understanding of our key profit/loss drivers. As a result, we reclassified $0.5 million and $1.6 million for the three months and nine months ended September 26, 2009, respectively, from Selling, general and administrative to Cost of services. This change did not have an impact on net loss.

Note Three Revenue Recognition

Behavioral Analytics Service Business Unit

Behavioral Analytics Service Line

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. 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. These costs are included in Prepaid expenses and Other long-term assets. 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.

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 Behavioral Analytics System and/or the number of hours of calls analyzed during the relevant month of the term of the subscription contract. This revenue is recognized as the service is performed for the client.

Consulting services revenue included in the Behavioral Analytics Service Line primarily consists of fees charged to our clients to provide post-deployment follow-on consulting services, which generally consist of custom data analysis, the implementation of enhancements, and training. These follow-on consulting services 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 term of the contract.

Marketing Managed Services Line

Marketing Managed Services revenue is derived from marketing application hosting and email fulfillment. Revenue related to hosting services is generally in the form of fixed monthly fees received from our clients and is recognized as the services are performed for each 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.

Table of Contents

Integrated Contact Solutions Business Unit

Integrated Contact Solutions Service Line

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 services 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 fee Managed services contracts, where the Company provides support for third-party software and hardware, revenue is recorded at the gross amount of the sale. If the contract does not meet the requirements for gross reporting, then Managed services revenue is recorded at the net amount of the sale.

Consulting services revenue included in the Integrated Contact Solutions Service Line consists of the modeling, planning, configuring, or integrating of an Internet Protocol (IP) network solution within our clients contact center environments. 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 term of the contract. For all other consulting services, we recognize revenue as the services are performed for the client.

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.

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, vendor-specific objective evidence (VSOE) must be determined for each of the individual elements. If VSOE does not exist for the allocation of revenue to the various elements of the arrangement, then 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, then the arrangement revenue is recognized ratably over the remaining service period.

Traditional CRM Service Line

Consulting services revenue included in the Company s traditional CRM Service Line consists of fees generated from our operational consulting and systems integration services or from building systems 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 term of the 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. For fixed-fee support, revenue is recognized ratably over the contract period. For time-and-material contracts, revenue is recognized as the services are provided to the client.

Multiple-element arrangements are segmented into separate earning processes when the elements have objective and reliable evidence of fair value and have value to the customer on a stand-alone basis. Revenue related to contracts with multiple elements is allocated based on the fair value of the element and is recognized in accordance with our revenue recognition policy for each type of element, as described above. If the fair value for any undelivered element cannot be established, then 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, then the revenue for the entire arrangement is recognized ratably over the service period.

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

5

Table of Contents

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.

Note Four Stock-Based Compensation

Stock-based compensation expense was $1.5 million and $1.3 million for the three months ended September 25, 2010 and September 26, 2009, respectively, and $4.5 million and $4.9 million for the nine months ended September 25, 2010 and September 26, 2009, respectively. The Company recognizes stock-based compensation expense on a straight-line basis over the vesting period. The Company has established its forfeiture rate based on historical experience.

As of September 25, 2010, there were a total of 1,076,466 shares of Common Stock available for future grants under the 1999 Plan, the 2000 Plan, and from treasury stock.

Restricted Stock

Restricted and installment stock award activity was as follows for the nine months ended September 25, 2010:

	Shares	Weighted Average Price
Nonvested balance at December 26, 2009	985,208	$ 7.14
Granted	530,100	$ 5.96
Vested	(518,653)	$ 7.37
Forfeited	(25,852)	$ 11.30
Nonvested balance at September 25, 2010	970,803	$ 6.26

	For the Three Months Ended		For the Nine Months Ended	
(In millions)	**Sept. 25, 2010**	**Sept. 26, 2009**	**Sept. 25, 2010**	**Sept. 26, 2009**
Total fair value of restricted and installment stock awards vested	$ 0.7	$ 0.6	$ 2.9	$ 2.3

As of September 25, 2010, there remained $5.0 million of unrecognized compensation expense related to restricted and installment stock awards. These costs are expected to be recognized over a weighted average period of 1.5 years.

Stock Options

The Company recognized compensation expense related to option awards of $0.3 million for both the three months ended September 25, 2010 and the three months ended September 26, 2009, and $0.9 million for both the nine months ended September 25, 2010 and the nine months ended September 26, 2009.

Table of Contents

Option activity was as follows for the nine months ended September 25, 2010:

	Options	Weighted Average Exercise Price
Outstanding as of December 26, 2009	1,231,205	$ 13.57
Granted	30,000	$ 6.34
Exercised	(895)	$ 2.73
Forfeited	(7,098)	$ 194.05
Outstanding as of September 25, 2010	1,253,212	$ 12.39
Exercisable as of September 25, 2010	926,173	$ 14.23
Outstanding intrinsic value at September 25, 2010 (in millions)	$ 1.3	
Exercisable intrinsic value at September 25, 2010 (in millions)	$ 0.9	

	For the Three Months Ended		For the Nine Months Ended	
(In millions)	Sept. 25, 2010	Sept. 26, 2009	Sept. 25, 2010	Sept. 26, 2009
Total fair value of stock options vested	$ 0.3	$ 0.3	$ 0.9	$ 1.1
Intrinsic value of stock options exercised				
Proceeds received from option exercises				

As of September 25, 2010, there remains $1.2 million of unrecognized compensation expense related to stock options. These costs are expected to be recognized over a weighted average period of 1.4 years.

The fair value for options granted during the nine months ended September 25, 2010 and September 26, 2009, was estimated on the date of grant using a Black-Scholes option-pricing model. The Company used the following assumptions:

	For the Nine Months Ended	
	Sept. 25, 2010	Sept. 26, 2009
Risk-free interest rates	1.8%	1.8%
Expected dividend yield		
Expected volatility	68%	66% 69%
Expected lives	6 years	6 years

Historical Company information is the primary basis for the selection of expected life, expected volatility, and expected dividend yield assumptions. 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.

Other Stock Compensation

ICS Performance Unit Awards

On November 3, 2009, the Compensation Committee approved the grant of 65,000 performance unit awards to certain employees of the Integrated Contact Solutions Business Unit and on May 5, 2010, the Compensation Committee approved the grant of an additional 22,000 performance unit awards. The performance period for the awards began on October 1, 2009 and ends on December 29, 2012. On the last day of the performance period, the performance units granted will become fully vested. The amount earned, if any, for each vested performance unit will vary based on (1) the ultimate value of the Integrated Contact Solutions Business Unit relative to the baseline value and (2) the number of participants receiving performance units (because a fraction of the total increase in Integrated Contact Solutions Business Unit value will fund an incentive pool that is divided among all participants based on the relative number of the performance units held by each participant at the end of the performance period). The distribution of this pool will be settled in shares of eLoyalty Common Stock; the number of shares issued will be determined based on the ultimate value of the incentive pool, divided by the 10-day average share price of eLoyalty Common Stock as of the distribution date.

Table of Contents

For the three months and nine months ended September 25, 2010, the Company expensed $0.2 million and $0.6 million for this program, respectively. The cost of this program is being expensed over a thirty-two month period. As of September 25, 2010, there remains $1.6 million of unrecognized compensation expense related to the ICS performance units. These costs are expected to be recognized over a weighted average period of 1.3 years. There are an estimated 380,170 shares of eLoyalty Common Stock potentially issuable with this program as of September 25, 2010.

Employee Stock Purchase Plan

The Employee Stock Purchase Plan is intended to qualify as an employee stock purchase plan under section 423 of the Internal Revenue Code. Eligible employees are permitted to purchase shares of Common Stock at below-market prices. Under this Plan, the purchase period opens on the first day of the calendar quarter and ends on the last business day of each calendar quarter. A total of 10,055 shares and 11,158 shares were issued during the three months ended September 25, 2010 and September 26, 2009, respectively, and 26,020 shares and 38,370 shares were issued during the nine months ended September 25, 2010 and September 26, 2009, respectively. We recorded $16 thousand and $23 thousand of expense for this plan for the three months ended September 25, 2010 and September 26, 2009, respectively, and $45 thousand and $67 thousand of expense for the nine months ended September 25, 2010 and September 26, 2009, respectively.

Note Five Severance and Related Costs

Severance costs are comprised primarily of contractual salary and related fringe benefits over the severance payment period. Facility costs include losses on contractual lease commitments, net of estimated sublease recoveries, and impairment of leasehold improvements and certain office assets.

For the third quarter of 2010, the Company recorded $0.1 million of expense related to severance and related costs for the elimination of eight positions. In the third quarter of 2009, the Company recorded $0.3 million of expense related to severance and related costs for the elimination of seven positions. For the first nine months of 2010, the Company recorded $0.9 million of expense related to severance and related costs for the elimination of fifty-five positions. In the first nine months of 2009, the Company recorded $1.0 million of expense related to severance and related costs for the elimination of twenty-six positions and an adjustment to sublease recoveries.

For the nine months ended September 25, 2010, the Company made cash payments of $0.9 million related to cost-reduction actions. For the nine months ended September 26, 2009, the Company made cash payments of $1.2 million related to cost-reduction actions. The cash payments in the first nine months of 2010 and 2009 were primarily related to severance and related costs, office space reductions, and office closures.

The severance and related costs and their utilization for the nine months ended September 25, 2010 and September 26, 2009 were as follows:

(In millions)	**Employee Severance**	**Facilities**	**Total**
Balance, December 26, 2009	$	$ 0.3	$ 0.3
Charges	0.9		0.9
Adjustments charged to severance and related costs			
Charged to severance and related costs	0.9		0.9
Payments	(0.8)	(0.1)	(0.9)
Balance, September 25, 2010	$ 0.1	$ 0.2	$ 0.3

Table of Contents

(In millions)	Employee Severance	Facilities	Total
Balance, December 27, 2008	$ 0.1	$ 0.4	$ 0.5
Charges	1.0		1.0
Adjustments charged to severance and related costs			
Charged to severance and related costs	1.0		1.0
Payments	(1.1)	(0.1)	(1.2)
Balance, September 26, 2009	$	$ 0.3	$ 0.3

As of September 25, 2010, the $0.3 million that remained reserved relates to severance payments and facility lease payments, net of estimated sublease recoveries, and these lease payments will be paid pursuant to contractual lease terms through February 2015. The $0.3 million balance is apportioned among Accrued Compensation and Related Costs , Other current liabilities , and Other long-term liabilities. As of September 26, 2009, the $0.3 million that remained reserved relates to facility lease payments, net of estimated sublease recoveries, and these lease payments will be paid pursuant to contractual lease terms through February 2015. The $0.3 million balance is apportioned between Other current liabilities and Other long-term liabilities.

Note Six Current Prepaid Expenses

Current prepaid expenses were $14.1 million and $10.1 million as of September 25, 2010 and December 26, 2009, respectively. Current prepaid expenses primarily consist of third-party support costs related to our Integrated Contact Solutions Managed services and deferred costs related to the Behavioral Analytics Service. These costs are recognized over the contract terms of the respective agreements, generally one to five years. Costs included in current prepaid expenses will be recognized within the next twelve months. Current prepaid expenses consisted of the following:

(In millions)	As of September 25, 2010	December 26, 2009
Integrated Contact Solutions prepaid third-party support costs	$ 8.8	$ 4.7
Behavioral Analytics Service deferred costs	2.0	2.6
Other	3.3	2.8
Total	$ 14.1	$ 10.1

Note Seven Intangible Assets, net

Net intangible assets were $0.4 million as of September 25, 2010 and $0.5 million as of December 26, 2009. Intangible assets reflect costs related to patent and trademark applications, Marketing Managed Services customer relationships acquired in 2004, and the 2003 purchase of a license for certain intellectual property. Patent and trademark applications are amortized over 120 months. The other intangible assets are fully amortized. Amortization expense of intangible assets for the nine months ended September 25, 2010 was $0.1 million and will be $0.1 million annually thereafter.

(In millions)	As of September 25, 2010	December 26, 2009
Gross intangible assets	$ 2.8	$ 2.8
Accumulated amortization of intangible assets	(2.4)	(2.3)

Total	$ 0.4	$ 0.5

9

Table of Contents

Note Eight Other Long-Term Assets

Other long-term assets were $11.5 million as of September 25, 2010 and $8.2 million as of December 26, 2009. Other long-term assets primarily consist of third-party support costs related to our Integrated Contact Solutions Managed services and deferred costs related to the Behavioral Analytics Service. These costs are recognized over the terms of the respective agreements, generally one to five years. Costs included in long-term assets will be recognized over the remaining term of the agreements beyond the first twelve months. Other long-term assets consisted of the following:

	As of	
(In millions)	**September 25, 2010**	**December 26, 2009**
Integrated Contact Solutions prepaid third-party support costs	$ 7.8	$ 4.1
Behavioral Analytics Service deferred costs	3.5	2.5
Other	0.2	1.6
Total	$ 11.5	$ 8.2

Note Nine Current Unearned Revenue

Current unearned revenue was $21.6 million as of September 25, 2010 and $20.4 million as of December 26, 2009. Current unearned revenue reflects prepayment by our clients in advance of our recognition of this revenue. Payments are generally received in advance from clients that are utilizing our Behavioral Analytics Service and Integrated Contact Solutions Managed services. Current unearned revenue will be recognized within the next twelve months and consisted of the following:

	As of	
(In millions)	**September 25, 2010**	**December 26, 2009**
Integrated Contact Solutions Managed Services	$ 14.4	$ 9.8
Behavioral Analytics Service Managed Services	7.0	10.4
Other	0.2	0.2
Total	$ 21.6	$ 20.4

Note Ten Long-Term Unearned Revenue

Long-term unearned revenue was $13.0 million and $9.5 million as of September 25, 2010 and December 26, 2009, respectively. Long-term unearned revenue reflects prepayment by our clients in advance of our recognition of this revenue. Payments are generally received in advance from clients that are utilizing our Behavioral Analytics Service and Integrated Contact Solutions Managed services. Long-term unearned revenue reflects revenue that will be recognized beyond the next twelve months and consisted of the following:

	As of	
(In millions)	**September 25, 2010**	**December 26, 2009**
Integrated Contact Solutions Managed Services	$ 9.8	$ 5.7
Behavioral Analytics Service Managed Services	3.2	3.8
Total	$ 13.0	$ 9.5

Table of Contents

Note Eleven Comprehensive Net Loss

Comprehensive net loss is comprised of the following:

(In millions)	For the Three Months Ended Sept. 25, 2010	Sept. 26, 2009	For the Nine Months Ended Sept. 25, 2010	Sept. 26, 2009
Net loss	$ (2.8)	$ (2.2)	$ (11.6)	$ (7.8)
Other comprehensive loss:				
Unrealized loss on marketable securities		(0.3)		(0.1)
Effect of currency translation	0.1	0.1		0.1
Comprehensive net loss	$ (2.7)	$ (2.4)	$ (11.6)	$ (7.8)

The accumulated other comprehensive loss, which represents the cumulative effect of foreign currency translation adjustments, was $3.7 million and $3.6 million at September 25, 2010 and December 26, 2009, respectively. In the third quarter of 2009, the unrealized loss on marketable securities related to stock of a publicly-traded company, which was classified as available-for-sale and the fair value was included in Other current assets. During the three months ended September 26, 2009, the Company sold these equity securities for $0.3 million.

Note Twelve Loss Per Share

The following table sets forth the computation of the loss and shares used in the calculation of basic and diluted loss per share:

(In millions)	For the Three Months Ended Sept. 25, 2010	Sept. 26, 2009	For the Nine Months Ended Sept. 25, 2010	Sept. 26, 2009
Net loss	$ (2.8)	$ (2.2)	$ (11.6)	$ (7.8)
Series B Stock dividends[1]	(0.3)	(0.3)	(0.9)	(1.0)
Net loss available to common stockholders	$ (3.1)	$ (2.5)	$ (12.5)	$ (8.8)
Per common share				
Basic net loss before Series B Stock dividends	$ (0.20)	$ (0.17)	$ (0.85)	$ (0.59)
Basic net loss available to common stockholders	$ (0.22)	$ (0.19)	$ (0.92)	$ (0.66)
(In thousands)				
Weighted average common shares outstanding	13,784	13,317	13,644	13,218
Currently antidilutive common stock equivalents[2]	3,741	4,277	3,986	4,129

(1) During the second quarter of 2010, the Company s Board of Directors declared a cash dividend of $0.1785 per share on the 7% Series B convertible preferred stock (Series B Stock) payable July 1, 2010.

(2) In periods in which there was a loss, the dilutive effect of common stock equivalents, which is primarily related to the Series B Stock, was not included in the diluted loss per share calculation as it was antidilutive.

Note Thirteen Leases

Capital Leases

The Company acquired $0.2 million and $0.9 million of computer equipment using capital leases in the first nine months of 2010 and in fiscal year 2009, respectively. These assets were related primarily to investments in our Behavioral Analytics™ Service Line. In 2009 and prior years, the Company was required to issue an irrevocable letter of credit for a portion of the lease amount as additional consideration for the duration of the executed lease agreement. In 2010, newly executed leases do not require an irrevocable letter of credit. There was $0.4 million of depreciation on capital leases in the third quarter of 2010 and in the third quarter of 2009, and $1.2 million and $1.0 million of depreciation on capital leases in the first nine months of 2010 and 2009, respectively. All capital leases are for terms of either thirty or thirty-six months. The liabilities for these capital leases are included in Other current liabilities and Other long-term liabilities on the balance sheet. We expect capital lease investments to increase between $1.5 million to $2.0 million for fiscal year 2010.

The following is a schedule, by year, of future minimum lease payments under capital leases, together with the present value of the net minimum lease payments as of September 25, 2010:

(In Millions) Year	Amount
2010	$ 0.5
2011	1.1
2012	0.3
2013	
2014	
Thereafter	
Total minimum lease payments	$ 1.9
Less: estimated executory costs	(0.2)
Net minimum lease payments	$ 1.7
Less: amount representing interest	(0.1)
Present value of minimum lease payments	$ 1.6

Note Fourteen Segment Information

The Company operates in two business segments, the Behavioral Analytics Service Business Unit and the Integrated Contact Solutions Business Unit. These segments are consistent with the Company s management of the business and reflect its internal financial reporting structure and operating focus.

The Behavioral Analytics Service Business Unit 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 managed hosted solution and is delivered as a subscription service. Revenue from follow-on consulting services, deployments, and subscription services, as well as marketing application hosting and email fulfillment services, are included in this Business Unit.

The Integrated Contact Solutions Business Unit 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 from Consulting services, Managed services, Product resale, traditional CRM, and remote application support services are included in this Business Unit.

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 GAAP. The Company does not allocate severance and related costs, depreciation and amortization or other items below the Operating Income/(Loss) level to its business segments. Also, the Company does not track or review asset information, other than capital investments, by reportable segments.

Table of Contents

The following table presents summarized information by business segment along with a reconciliation to operating loss:

(In millions)	Segment Reporting Three Months Ended September 25, 2010 Behavioral Analytics Service Business Unit	Integrated Contact Solutions Business Unit	Corporate	Total
Revenue				
Services	$ 6.8	$ 11.3	$	$ 18.1
Product		4.2		4.2
Net revenue	6.8	15.5		22.3
Reimbursed expenses	0.1	0.9		1.0
Total revenue	6.9	16.4		23.3
Segment operating (loss)/income before stock-based compensation, severance and related costs and depreciation and amortization	(0.6)	2.9	(2.4)	(0.1)
Stock-based compensation	0.9	0.4	0.2	1.5
Severance and related costs			0.1	0.1
Depreciation and amortization			1.0	1.0
Operating (loss)/income	(1.5)	2.5	(3.7)	(2.7)
Interest and other (expense)/income			(0.1)	(0.1)
Income taxes				
Loss on discontinued operations				
Net (loss)/income	$ (1.5)	$ 2.5	$ (3.8)	$ (2.8)
Capital investments	$ 0.2	$ 0.3	$ 0.1	$ 0.6

(In millions)	Segment Reporting Three Months Ended September 26, 2009 Behavioral Analytics Service Business Unit	Integrated Contact Solutions Business Unit	Corporate	Total
Revenue				
Services	$ 5.4	$ 14.3	$	$ 19.7
Product		2.0		2.0
Net revenue	5.4	16.3		21.7
Reimbursed expenses		1.0		1.0
Total revenue	5.4	17.3		22.7
Segment operating (loss)/income before stock-based compensation, severance and related costs and depreciation and amortization	(1.1)	3.4	(2.1)	0.2
Stock-based compensation	0.7	0.3	0.3	1.3
Severance and related costs			0.3	0.3

Depreciation and amortization			1.1	1.1
Operating (loss)/income	(1.8)	3.1	(3.8)	(2.5)
Interest and other income/(expense)			0.3	0.3
Income taxes				
Loss on discontinued operations				
Net (loss)/income	$ (1.8)	$ 3.1	$ (3.5)	$ (2.2)
Capital investments	$ 0.5	$ 0.1	$ 0.2	$ 0.8

Table of Contents

(In millions)	Behavioral Analytics Service Business Unit	Integrated Contact Solutions Business Unit	Corporate	Total
	Segment Reporting Nine Months Ended September 25, 2010			
Revenue				
Services	$ 20.2	$ 32.2	$	$ 52.4
Product		10.2		10.2
Net revenue	20.2	42.4		62.6
Reimbursed expenses	0.4	2.3		2.7
Total revenue	20.6	44.7		65.3
Segment operating (loss)/income before stock-based compensation, severance and related costs and depreciation and amortization	(2.2)	5.7	(6.3)	(2.8)
Stock-based compensation	2.5	1.1	0.9	4.5
Severance and related costs			0.9	0.9
Depreciation and amortization			3.1	3.1
Operating (loss)/income	(4.7)	4.6	(11.2)	(11.3)
Interest and other (expense)/income			(0.1)	(0.1)
Income taxes			(0.1)	(0.1)
Loss on discontinued operations			(0.1)	(0.1)
Net (loss)/income	$ (4.7)	$ 4.6	$ (11.5)	$ (11.6)
Capital investments	$ 0.9	$ 1.5	$ 0.2	$ 2.6

(In millions)	Behavioral Analytics Service Business Unit	Integrated Contact Solutions Business Unit	Corporate	Total
	Segment Reporting Nine Months Ended September 26, 2009			
Revenue				
Services	$ 14.9	$ 44.9	$	$ 59.8
Product		14.8		14.8
Net revenue	14.9	59.7		74.6
Reimbursed expenses	0.2	2.8		3.0
Total revenue	15.1	62.5		77.6
Segment operating (loss)/income before stock-based compensation, severance and related costs and depreciation and amortization	(3.2)	10.7	(6.3)	1.2
Stock-based compensation	2.6	1.2	0.9	4.7
Severance and related costs			1.0	1.0
Depreciation and amortization			3.4	3.4
Operating (loss)/income	(5.8)	9.5	(11.6)	(7.9)
Interest and other income/(expense)			0.1	0.1
Income taxes				

Loss on discontinued operations				
Net (loss)/income	$ (5.8)	$ 9.5	$ (11.5)	$ (7.8)
Capital investments	$ 3.0	$ 0.4	$ 0.5	$ 3.9

14

Table of Contents

Note Fifteen Fair Value Measurements

The Company reports certain assets and liabilities at fair value. Fair value is an exit price and establishes a three-tier valuation hierarchy for ranking the quality and reliability of the information used to determine fair values. The first tier, Level 1, uses quoted market prices in active markets for identical assets or liabilities. Level 2 uses inputs, other than quoted market prices for identical assets or liabilities in active markets, which are observable either directly or indirectly. Level 3 uses unobservable inputs in which there are little or no market data, and requires the entity to develop its own assumptions. A financial asset or liability s classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

The following table provides the assets and liabilities carried at fair value measured on a recurring basis:

		Fair Value Measurements at September 25, 2010 Using		
(In millions)	**Total carrying at Sept. 25, 2010**	**Quoted Prices in Active Markets (Level 1)**	**Other Observable (Level 2)**	**Significant Unobservable (Level 3)**
Money market fund	$ 11.5	$ 11.5	$	$

		Fair Value Measurements at December 26, 2009 Using		
(In millions)	**Total carrying at Dec. 26, 2009**	**Quoted Prices in Active Markets (Level 1)**	**Other Observable (Level 2)**	**Significant Unobservable (Level 3)**
Money market fund	$ 23.5	$ 23.5	$	$

During fiscal year 2009, the Company sold its equity securities in a publicly-traded company for $0.3 million. These marketable securities were classified as available for sale and were included in Other current assets on the Company s balance sheet. Unrealized holding gains and losses were excluded from earnings and reported in other comprehensive income until realized.

Note Sixteen Fair Value of Financial Instruments

The carrying values of current assets and liabilities approximated their fair values as of September 25, 2010 and December 26, 2009. The Company considers all highly liquid investments readily convertible into known amounts of cash (with purchased maturities of three months or less) to be cash equivalents.

Note Seventeen Recent Accounting Pronouncements

In October 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2009-13, Revenue Recognition (Accounting Standards Codification ASC Topic 605) Multiple-Deliverable Revenue Arrangements, a consensus of the FASB Emerging Issues Task Force. This guidance modifies the fair value requirements of ASC subtopic 605-25, Revenue Recognition-Multiple Element Arrangements, by allowing the use of the best estimate of selling price in addition to VSOE and vendor objective evidence (VOE) (now referred to as TPE, standing for third-party evidence) for determining the selling price of a deliverable. A vendor is now required to use its best estimate of the selling price when VSOE or TPE of the selling price cannot be determined. In addition, the residual method of allocating arrangement consideration is no longer permitted.

In October 2009, the FASB also issued ASU No. 2009-14, Software (ASC Topic 985) Certain Revenue Arrangements That Include Software Elements, a consensus of the FASB Emerging Issues Task Force. This guidance modifies the scope of ASC subtopic 965-605, Software-Revenue Recognition, to exclude from its requirements (a) non-software components of tangible products and (b) software components of tangible products that are sold, licensed, or leased with tangible products when the software components and non-software components of the tangible product function together to deliver the tangible product s essential functionality.

15

Table of Contents

ASU No. 2009-13 and ASU No. 2009-14 require expanded qualitative and quantitative disclosures and are effective for fiscal years beginning on or after June 15, 2010. However, companies were permitted to elect to adopt these expanded disclosures as early as interim periods ended September 30, 2009. These updates may be applied either prospectively from the beginning of the fiscal year for new or materially modified arrangements or retrospectively. We are currently evaluating the impact of adopting these updates on our consolidated financial statements.

In January 2010, the FASB issued ASU No. 2010-06, which provides new guidance related to the disclosures about transfers into and out of Levels 1 and 2 fair value classifications and separate disclosures about purchases, sales, issuances, and settlements relating to the Level 3 fair value classification. The Company s financial assets and liabilities are typically measured using Level 1 inputs. The new guidance also clarifies existing fair value disclosures about the level of disaggregation and about inputs and valuation techniques used to measure the fair value. In addition, the new guidance amends guidance on employers disclosures about post-retirement benefit plan assets to require that disclosures be provided by classes of assets instead of by major categories of assets. The adoption of this guidance did not have an impact on our consolidated financial statements.

In February 2010, the FASB issued an amendment to the guidance on Subsequent Events, ASU No. 2010-09, which removed the requirement for an SEC registrant to disclose the date through which subsequent events are evaluated. It did not change the accounting for or disclosure of events that occur after the balance sheet date but before the financial statements are issued. This amendment was effective upon issuance. The adoption of ASU No. 2010-09 had no material effect on our consolidated financial statements.

In April 2010, the FASB issued ASU No. 2010-17, Revenue Recognition (ASC 605). This update provides guidance on the criteria that should be met for determining whether the milestone method of revenue recognition is appropriate. This guidance became effective for fiscal years, and interim periods within those years, beginning on or after June 15, 2010. We are currently evaluating the impact of adopting these updates on our consolidated financial statements.

In July 2010, the FASB issued ASU No. 2010-20, Receivables (ASC 310). This guidance relates to the credit quality of financing receivables and the allowance for credit losses. This guidance will require additional disclosures about the credit quality of financing receivables in the financial statements including, but not limited to, significant purchases and sales of financing receivables, aging information, and credit quality indicators. The additional disclosures will be effective for periods ending on or after December 15, 2010. We are currently evaluating the impact of adopting these updates on our consolidated financial statements.

During 2010, the FASB issued several ASUs, ASU No. 2010-01 through ASU No. 2010-25, and during 2009, ASU No. 2009-02 through ASU No. 2009-17. Except for ASUs No. 2009-13, 2009-14, 2010-06, 2010-09, 2010-17 and 2010-20 the ASUs entail technical corrections to existing guidance or affect guidance related to specialized industries and therefore have minimal, if any, impact on the Company.

Note Eighteen Litigation and Other Contingencies

From time to time, the Company 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.

The Company is a party to various agreements, including substantially all major services agreements and intellectual property licensing agreements, under which it may be obligated to indemnify the other party with respect to certain matters, including, but not limited to, indemnification against third-party claims of infringement of intellectual property rights with respect to software and other deliverables provided by us in the course of our engagements. These obligations may be subject to various limitations on the remedies available to the other party, including, without limitation, limits on the amounts recoverable and the time during which claims may be made, and may be supported by indemnities given to the Company by applicable third parties. Payment by the Company under these indemnification clauses is generally subject to the other party making a claim that is subject to challenge by the Company and dispute resolution procedures specified in the particular agreement. Historically, the Company has not been obligated to pay any claim for indemnification under its agreements and management is not aware of future indemnification payments that it would be obligated to make.

Table of Contents

Under its By-Laws, subject to certain exceptions, the Company has agreed to indemnify its officers and directors for certain events or occurrences while the officer or director is, or was, serving at its request in such capacity or in certain related capacities. The Company has separate indemnification agreements with each of its directors and officers that requires it, subject to certain exceptions, to indemnify them to the fullest extent authorized or permitted by its By-Laws and the Delaware General Corporation Law. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a director and officer liability insurance policy that limits its exposure and enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal. The Company has no liabilities recorded for these agreements as of September 25, 2010.

Item 2. 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 condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, 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, and 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.

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

Revenue Recognition

Behavioral Analytics Service Business Unit

Behavioral Analytics Service Line

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. 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. These costs are included in Prepaid expenses and Other long-term assets. 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.

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 Behavioral Analytics System and/or the number of hours of calls analyzed during the relevant month of the term of the subscription contract. This revenue is recognized as the service is performed for the client.

Consulting services revenue included in the Behavioral Analytics Service Line primarily consists of fees charged to our clients to provide post-deployment follow-on consulting services, which generally consist of custom data analysis, the implementation of enhancements, and training. These follow-on consulting services 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 term of the contract.

Table of Contents

Marketing Managed Services Line

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 term of the hosting contract. 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 Solutions Business Unit

Integrated Contact Solutions Service Line

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. If the contract does not meet the requirements for gross reporting, then Managed services revenue is recorded at the net amount of the sale.

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 environments. 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 term of the contract. For all other consulting services, we recognize revenue as the services are performed for the client.

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.

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, VSOE must be determined for each of the individual elements. If VSOE does not exist for the allocation of revenue to the various elements of the arrangement, then 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 PCS or other deliverables with similar attribution periods, then the arrangement revenue is recognized ratably over the remaining service period.

Traditional CRM Service Line

Consulting services revenue included in the Company s traditional CRM Service Line consists of fees generated from our operational consulting and systems integration services or from building systems 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 term of the 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. For fixed-fee support revenue is recognized ratably over the contract period. For time-and-material contracts revenue is recognized as the services are provided to the client.

Multiple-element arrangements are segmented into separate earning processes when the elements have objective and reliable evidence of fair value and have value to the customer on a stand-alone basis. Revenue related to contracts with multiple elements is allocated based on the fair value of the element and is recognized in accordance with our revenue recognition policy for each type of element, as described above. If the fair value for any undelivered element cannot be established, then 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, then the revenue for the entire arrangement is recognized ratably over the service period.

Reimbursed expenses revenue includes billable costs related to travel and other out-of-pocket expenses incurred while performing services for our clients. The cost of third-party product and support may be included within this category if the transaction does not satisfy the requirements for gross reporting. 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.

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

Stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the vesting period. Determining fair value of stock-based awards at the grant date requires certain assumptions. The Company uses historical information as 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.

Severance and Related Costs

We recorded accruals for severance and related costs associated with our cost-reduction efforts undertaken during fiscal years 2001 through 2010. The portion of the accruals relating to employee severance represents contractual severance for identified employees and generally is not subject to a significant revision. The portion of the accruals that related to office space reductions, office closures, and associated contractual lease obligations are based in part on assumptions and estimates of the timing and amount of sublease rentals, which may be 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. There was no adjustment made to sublease efforts in the first nine months of 2010, compared to a favorable adjustment of $0.1 million in fiscal year 2009 .

Income Taxes

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.

The Company uses an asset and liability approach 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, FASB addressed whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under this guidance, 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. There is additional guidance on derecognition, classification, interest, and penalties on income taxes, accounting in interim periods, and disclosure requirements.

Table of Contents

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 our Annual Report filed on Form 10-K for the year ended December 26, 2009.

Forward-Looking Statements

This Quarterly Report on Form 10-Q (this Form 10-Q) 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, future, should, could, seeks, target, may, will continue to, predicts, forecasts, potential, guidance, expressions, references to plans, 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 Form 10-K for the year ended December 26, 2009, 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;

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

- Variances in sales of products in connection with client engagements;

- Management of the other risks associated with increasingly complex client projects and new service offerings, including execution risk;

- Management of growth and development and introduction of new service offerings, including those related to the Behavioral Analytics Service;

- Challenges in attracting, training, motivating, and retaining highly-skilled management, strategic, technical, product development, and other professional employees in a competitive information-technology labor market;

- Risks associated with our reliance on Cisco Systems, Inc., a large primary product partner within our Integrated Contact Solutions Service Line, including our reliance on its product positioning, pricing, and discounting strategies;

- Reliance on major suppliers, including CRM software providers and other alliance partners, and maintenance of good relations with key business partners;

Continuing intense competition in the information-technology services industry generally and, in particular, among those focusing on the provision of CRM services and software;

The rapid pace of technological innovation in the information-technology services industry;

Protection of our technology, proprietary information, and other intellectual property rights from challenges by others;

The ability to raise sufficient amounts of debt or equity capital to meet our future operating and financial needs;

The outcome of strategic alternatives being evaluated with respect to our Integrated Contract Solutions Business Unit;

Risks associated with compliance with international, federal, and state privacy and security laws, and the protection of highly confidential information of clients and their customers;

Future legislative or regulatory actions relating to information technology or the information-technology service industry, including those relating to data privacy and security;

Changes by the FASB or the SEC of authoritative accounting principles generally accepted in the United States or policies or changes in the application or interpretation of those rules or regulations;

Table of Contents

Risks associated with global operations, including those relating to the economic conditions in each country, potential currency exchange and credit volatility, compliance with a variety of foreign laws and regulations, and management of a geographically-dispersed organization;

Economic, business, and political conditions and the effects of these conditions on our clients businesses and levels of business activity;

Acts of war or terrorism, including, but not limited to, actions taken or to be taken by the United States and other governments as a result of acts or threats of terrorism, and the impact of these acts on economic, financial, and social conditions in the countries where we operate; and

The timing and occurrence (or non-occurrence) of transactions and events which may be subject to circumstances beyond our control. Readers are cautioned not to place undue reliance on forward-looking statements. They reflect opinions, assumptions, and estimates only as of the date they are made, and the Company undertakes no obligation to publicly update or revise any forward-looking statements in this Form 10-Q, whether as a result of new information, future events, or circumstances or otherwise.

Background

eLoyalty helps its clients achieve breakthrough 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. 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.

Business Unit	Managed Services Revenue	Consulting Services Revenue	Product Revenue
Behavioral Analytics Service	Subscription and amortized deployment revenue; marketing application hosting and email fulfillment revenue	Follow-on consulting revenue	None

Integrated Contact Solutions	Contact center monitoring and support revenue; remote application support revenue