

EGAIN COMMUNICATIONS CORP  
Form 10-Q  
May 15, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

\_\_\_\_\_  
**FORM 10-Q**  
\_\_\_\_\_

(Mark One)

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

For the quarterly period ended March 31, 2006

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 0-30260

\_\_\_\_\_  
**eGAIN COMMUNICATIONS CORPORATION**  
\_\_\_\_\_

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction  
of incorporation or organization)

345 E. Middlefield, Mountain View, CA

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

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(Address of principal executive offices)

94043

(Zip Code)

(650) 230-7500

(Registrant's telephone number, including area code)

N/A

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act): Yes  No

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

Class	Outstanding at March 31, 2006
Common Stock \$0.001 par value	15,306,713

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**eGAIN COMMUNICATIONS CORPORATION**

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

**eGAIN COMMUNICATIONS CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands)

	March 31, 2006 (unaudited)	June 30, 2005
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 5,479	\$ 4,498
Restricted cash	12	12
Accounts receivable, net	4,627	4,590
Prepaid and other current assets	846	1,125
<b>Total current assets</b>	<b>10,964</b>	<b>10,225</b>
Property and equipment, net	1,082	741
Goodwill	4,880	4,880
Other assets	305	58
	<b>\$ 17,231</b>	<b>\$ 15,904</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,031	\$ 1,109
Accrued compensation	1,486	1,386
Accrued liabilities	1,151	1,190
Deferred revenue	4,676	4,144
Accrued restructuring	17	17
Current portion of bank borrowings	1,393	1,585
<b>Total current liabilities</b>	<b>9,737</b>	<b>9,431</b>
Related party notes payable	8,369	7,579
Bank borrowing, net of current portion	92	69
Other long term liabilities	220	229
<b>Total liabilities</b>	<b>18,418</b>	<b>17,308</b>
Commitments		
Stockholders' deficit:		
Common stock	15	15
Additional paid-in capital	315,682	315,467
Notes receivable from stockholders	(73)	(72)
Accumulated other comprehensive loss	(489)	(456)
Accumulated deficit	(316,322)	(316,358)
<b>Total stockholders' deficit</b>	<b>(1,187)</b>	<b>(1,404)</b>

**See accompanying notes**

**Table of Contents****eGAIN COMMUNICATIONS CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share data)****(unaudited)**

	<b>Three Months</b>		<b>Nine Months</b>	
	<b>Ended March 31, 2006</b>	<b>2005</b>	<b>Ended March 31, 2006</b>	<b>2005</b>
<b>Revenue:</b>				
License	\$ 1,859	\$ 1,071	\$ 5,249	\$ 3,728
Support and Services	4,275	3,607	12,117	10,858
Total revenue	6,134	4,678	17,366	14,586
Cost of license	29	57	215	306
Cost of support and services	1,828	1,569	5,130	4,536
Gross profit	4,277	3,052	12,021	9,744
<b>Operating costs and expenses:</b>				
Research and development	782	571	2,199	1,633
Sales and marketing	2,588	2,127	6,973	6,434
General and administrative	585	815	1,953	2,413
Restructuring and other		14		(944)
Total operating costs and expenses	3,955	3,527	11,125	9,536
Income from operations	322	(475)	896	208
Interest and other expense	(234)	(250)	(860)	(773)
Net income / (loss)	88	(725)	36	(565)
Dividends on convertible preferred stock				(3,732)
Net income / (loss) applicable to common stockholders	\$ 88	\$ (725)	\$ 36	\$ (4,297)
 <b>Per Share information:</b>				
Basic net income / (loss) per common share	\$ 0.01	\$ (0.05)	\$ 0.00	\$ (0.54)
Diluted net income / (loss) per common share	\$ 0.01	\$ (0.05)	\$ 0.00	\$ (0.54)
Weighted average shares used in computing basic net income / (loss) per common share	15,305	15,288	15,303	7,885
Weighted average shares used in computing diluted net income / (loss) per common share	15,978	15,288	15,620	7,885

Below is a summary of stock based compensation included in the costs and expenses above:

Cost of support and services	\$ 7	\$	\$ 27	\$
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Research and development	9	39
Sales and marketing	27	64
General and administrative	19	83
Total stock-based compensation expense	\$ 62	\$ 213

See accompanying notes

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

	<b>Nine Months</b>	
	<b>Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash flows from operating activities:</b>		
Net income / (loss)	\$ 36	\$ (565)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation	282	262
Loss on disposal of fixed assets		16
Stock-Based Compensation	213	
Provisions for doubtful accounts and sales returns	(19)	(4)
Accrued interest and amortization of discount on related party notes	791	717
Changes in operating assets and liabilities:		
Accounts receivable	(181)	(525)
Prepaid and other current assets	263	222
Other assets	(247)	184
Accounts payable	(68)	(107)
Accrued compensation	116	145
Accrued liabilities	(7)	(47)
Accrued restructuring	(17)	(1,308)
Deferred revenue	624	270
Other long term liabilities	(9)	(10)
Other		(1)
Net cash (used in) provided by operating activities	1,777	(751)
<b>Cash flows from investing activities:</b>		
Purchases of property and equipment	(620)	(489)
Net cash used in investing activities	(620)	(489)
<b>Cash flows from financing activities:</b>		
Payments on borrowings	(4,587)	(1,871)
Payments on capital lease obligations		(9)
Proceeds from borrowings	4,417	2,984
Net proceeds from issuance of common stock	1	2
Net cash (used in) provided by financing activities	(169)	1,106
Effect of exchange rate differences on cash	(7)	(153)
Net increase (decrease) in cash and cash equivalents	981	(287)
Cash and cash equivalents at beginning of period	4,498	5,181
Cash and cash equivalents at end of period	\$ 5,479	\$ 4,894
<b>Supplemental cash flow disclosures:</b>		
Cash paid for interest	\$ 36	\$ 163



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Cash paid for taxes		91	154
<b>Non cash item:</b>			
Conversion of preferred stock to common stock		\$	\$ 112,486
	<b>See accompanying notes</b>		

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**eGAIN COMMUNICATIONS CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

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

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

Certain information and footnote disclosures, normally included in financial statements prepared in accordance with generally accepted accounting principles, have been condensed or omitted pursuant to such rules and regulations. In our opinion, the unaudited condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of our financial position, results of operations and cash flows for the periods presented. These financial statements and notes should be read in conjunction with our audited consolidated financial statements and notes thereto for the fiscal year ended June 30, 2005, included in our Annual Report on Form 10-K. The condensed consolidated balance sheet at June 30, 2005 has been derived from audited financial statements as of that date but does not include all the information and footnotes required by generally accepted accounting principles for complete financial statements. The results of our operations for the interim periods presented are not necessarily indicative of results that may be expected for any other interim period or for the full fiscal year ending June 30, 2006.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The estimates are based upon information available as of the date of the financial statements. Actual results could differ from those estimates.

**Note 2. Software Revenue Recognition**

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

We apply the provisions of Statement of Position ( SOP ) 97-2, *Software Revenue Recognition*, as amended by SOP 98-9 *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions* to all transactions involving the licensing of software products. In the event of a multiple element arrangement, we evaluate the transaction as if each element represents a separate unit of accounting taking into account all factors following the guidelines set forth in Emerging Issues Task Force Issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*, ( EITF 00-21 ). For fixed fee arrangements the services revenues are recognized in accordance with the provisions of SOP 81-1, *Accounting for Performance of Construction Type and Certain Production Type Contracts*, when reliable estimates are available for the costs and efforts necessary to complete the implementation services. When such estimates are not available, the completed contract method is utilized.

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When licenses are sold together with system implementation and consulting services, license fees are recognized upon shipment, provided that (i) payment of the license fees is not dependent upon the performance of the consulting and implementation services, (ii) the services are available from other vendors, (iii) the services qualify for separate accounting as we have sufficient experience in providing such services and we have vendor specific objective evidence pricing, and (iv) the services are not essential to the functionality of the software. For arrangements that do not meet the above criteria, both the product license revenues and the service revenues are recognized under the percentage of completion method. This has not been necessary in the last three years.

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

### *License Revenue*

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

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

We periodically sell to resellers. Revenue from sales to resellers is recognized either upon delivery to the reseller or on a sell-through basis depending on the facts and circumstances of the transaction, such as our understanding of the reseller's plans to sell the software, if there are any return provisions, price protection or other allowances, the reseller's financial status and our past experience with the particular reseller. Historically sales to resellers have not included any return provisions, price protections or other allowances.

### *Professional Services Revenue*

Included in support services revenues are revenues derived from system implementation consulting and training. The majority of our consulting and implementation services and accompanying agreements qualify for separate accounting. For hosting implementation services that do not qualify for separate accounting, we recognize the services revenue ratably over the remaining term of the hosting agreement. We use vendor specific objective evidence of fair value for the services and maintenance to account for the arrangement using the residual method, regardless of any separate prices stated within the contract for each element. Our consulting and implementation service contracts are bid either on a fixed-fee basis or on a time-and-materials basis. For time-and-materials contracts, we recognize revenue as services are performed. For a fixed-fee contract, we recognize revenue based upon the costs and efforts to complete the services in accordance with the percentage of completion method.

Training revenue is recognized when training is provided.

### *Hosting Services Revenue*

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

We evaluate whether each of the elements in these arrangements represents a separate unit of accounting, as defined by EITF 00-21, using all applicable facts and circumstances, including whether (i) we sell or could readily sell the element unaccompanied by the other elements, (ii) the element has stand-alone value to the customer, (iii) there is objective reliable evidence of the fair value of the undelivered item, and (iv) there is a general right of return.

We allocate the arrangement consideration to the separate units of accounting based on their relative fair values, as determined by the price of the undelivered items when sold separately. Assuming all other criteria are met (i.e., evidence of an arrangement exists, collectibility is probable, and fees are fixed or determinable), revenue is recognized as follows:

Hosting services are recognized ratably over the term of the initial hosting contract;  
Professional services are recognized as described above under Professional Services Revenue ; and  
License revenue is recognized as described above under License Revenue.

We consider the applicability of EITF 00-03 on a contract-by-contract basis. In hosted term-based agreements, where the customer does not have the contractual right to take possession of the software, the revenue is recognized on a monthly basis over the term of the contract. Amounts that have been invoiced are recorded in accounts receivable and in deferred revenue or revenue, depending on whether the revenue recognition criteria have been met. If we determine that the customer has the contractual right to take possession of our software at any time during the hosting period without significant penalty, and can feasibly run the software on its own hardware or enter into another arrangement with a third party to host the software, a software element covered by SOP 97-2 exists. When a software element exists in a hosting services arrangement, we recognize the license, professional services and hosting services revenues pursuant to SOP 97-2, whereby the fair value of the hosting service is recognized as revenue ratably over the term of the hosting contract. We have established vendor specific objective evidence for the hosting and support elements of perpetual license sales, based on the prices charged when sold separately and substantive renewal terms. Accordingly, revenue for the perpetual software license element is determined using the residual method and is recognized upon delivery. Revenue for the hosting and support elements is recognized ratably over the contractual time period.

If evidence of fair value cannot be established for the undelivered elements of an agreement, the entire amount of revenue from the arrangement is recognized ratably over the period that these elements are delivered. For implementation services that we determine do not have stand-alone value to the customer, we recognize the services revenue ratably over the remaining term of the hosting agreement.

*Maintenance and Support Revenue*

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

**Note 3. Stock-Based Compensation**

We adopted Statement of Financial Accounting Standards ( SFAS ) No. 123 (revised 2004), *Share-Based Payment*, ( SFAS 123R ) effective July 1, 2005. SFAS 123R requires the recognition of the fair value of stock compensation in net income. We recognize the stock compensation expense over the requisite service period of the

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individual grantees, which generally equals the vesting period. All of our stock compensation is accounted for as an equity instrument. Prior to July 1, 2005, we followed Accounting Principles Board ( APB ) Opinion 25, *Accounting for Stock Issued to Employees*, ( APB 25 ) and related interpretations in accounting for our stock compensation.

We have elected the modified prospective transition method for adopting SFAS 123R. Under this method, the provisions of SFAS 123R apply to all awards granted or modified after the date of adoption. We had no unearned stock compensation liability recorded on our balance sheet as of June 30, 2005. In addition, the unrecognized expense of awards not yet vested at the date of adoption shall be recognized in net income in the periods after the date of adoption using the same valuation method (*i.e.* Black-Scholes) and assumptions determined under the original provisions of SFAS 123, *Accounting for Stock-Based Compensation*, as disclosed in our previous filings. As a result of our adoption of SFAS 123R, we recognized \$62,000 and \$213,000 in stock compensation expense on our unaudited condensed consolidated statement of operations for the three and nine months ended March 31, 2006. The table below summarizes the effect of adoption of SFAS 123R.

	Three months ended March 31, 2006	Nine months ended March 31, 2006
Non-cash stock-based compensation expense	\$ (62)	\$ (213)
Income tax benefit		
Net income effect of adoption	\$ (62)	\$ (213)
Net effect earnings per share (basic and diluted) of adoption	\$	\$ (0.02)

We utilized the Black-Scholes valuation model for estimating the fair value of the stock compensation granted after the adoption of SFAS 123R. During the three months ended March 31, 2006, there were 29,750 options granted. All shares of our common stock issued pursuant to the company's stock option plans are only issued out of an authorized reserve of shares of common stock which were previously registered on Form S-8. The weighted-average fair values of the options granted under our stock option plans for the period was \$0.96 using the following assumptions:

	Three months ended March 31, 2006
Dividend yield	
Expected volatility	92%
Average risk-free interest rate	4.55%
Expected life (in years)	6.25

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

In developing our estimate of expected life, we determined that our historical share option exercise experience does not provide a reasonable basis upon which to estimate expected life. In addition, estimating life based on the expected terms of options granted by other, similar companies with similarly structured awards was considered but data was not readily available to arrive at reliable estimates. We therefore used the technique commonly referred to as the SEC Shortcut Approach. In SAB 107 the SEC staff described a temporary shortcut approach to developing the estimate of the expected life of a plain vanilla employee stock option. Under this approach, the

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expected life would be presumed to be the mid-point between the vesting date and the end of the contractual term. The shortcut approach is not permitted for options granted, modified or settled after December 31, 2007.

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

SFAS 123R requires us to present pro forma information for the comparative period prior to the adoption as if we had accounted for all our employee stock options under the fair value method of the original SFAS 123. The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation to the prior-year period (dollars in thousands, except per-share data).

	<b>Three months ended March 31, 2005</b>	<b>Nine months ended March 31, 2005</b>
Net loss as reported	(725)	(4,297)
Add: employee stock compensation included in reported net loss		
Less: employee stock compensation under SFAS No. 123	(38)	(40)
Pro forma net loss	(763)	(4,337)
Net loss per basic and diluted share as reported	(0.05)	(0.54)
Pro forma net loss per basic and diluted share	(0.05)	(0.55)

During the three and nine months ended March 31, 2005, there were approximately 16,200 and 18,200 options granted.

We account for stock-based compensation under SFAS 123R for the period after its adoption, and in accordance with APB 25, using the intrinsic value method (pro forma disclosure) for the period prior to the adoption of SFAS 123R. Total compensation cost of all options granted but not yet vested as of March 31, 2006 was \$257,000 which is expected to be recognized over the weighted average period of 3.32 years. Effective July 1, 2005, we adopted FAS 123(R), Share-Based Payments, and used the modified prospective method to value our share-based payments. Accordingly, for the three and nine months ended March 31, 2006, stock-based compensation was accounted under FAS 123(R) while for the three and nine months ended March 31, 2005, stock-based compensation was accounted under APB 25, Accounting for Stock Issued to Employees. During the three and nine months ended March 31, 2006, 5,165 options were exercised. There is no tax benefit related to these options exercised.

**Note 4. Net Income / (Loss) Per Common Share**

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

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The following table sets forth a reconciliation of shares used in calculating basic and diluted earnings per share:

	Three Months		Nine Months	
	Ended March 31,		Ended March 31,	
	2006	2005	2006	2005
Weighted average shares outstanding used in computing basic net income / (loss) per common share	15,305	15,288	15,303	7,885
Effect of dilutive securities	673		317	
Weighted average shares outstanding used in computing diluted net income / (loss) per common share	15,978	15,288	15,620	7,885

Outstanding options and warrants to purchase approximately 762,000 and 1,083,100 shares of common stock at March 31, 2006 and 2005, respectively, were not included in the computation of diluted net income / (loss) per common share for the periods presented as a result of their anti-dilutive effect. Such securities could have a dilutive effect in future periods.

**Note 5. Comprehensive Income / (Loss)**

We report comprehensive income / (loss) and the components in accordance with Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income ( SFAS 130 ). Under SFAS 130, comprehensive income includes all changes in equity during a period except those resulting from investments by or distributions to owners. The comprehensive income was \$132,000 for the quarter ended March 31, 2006 and the comprehensive loss was \$765,000 for the quarter ended March 31, 2005. Comprehensive income was \$3,000 for the nine months ended March 31, 2006 and comprehensive loss was \$718,000 for the nine months ended March 31, 2005. Accumulated other comprehensive loss presented in the accompanying consolidated balance sheets at March 31, 2006 and June 30, 2005 consists solely of accumulated foreign currency translation adjustments.

(in thousands)	Three Months		Nine Months	
	Ended March 31,		Ended March 31,	
	2006	2005	2006	2005
Net income / (loss)	\$ 88	\$ (725)	\$ 36	\$ (565)
Adj: foreign exchange translation	44	(40)	(33)	(153)
Comprehensive income / (loss)	\$ 132	\$ (765)	\$ 3	\$ (718)

**Note 6. Segment Information**

We operate in one segment, the development, license, implementation and support of our customer service infrastructure software solutions. Operating segments are identified as components of an enterprise for which discrete financial information is available and regularly reviewed by the company's chief operating decision-maker to make decisions about resources to be allocated to the segment and assess its performance. Our chief operating decision-makers, as defined under SFAS No. 131, are the members of our executive management team. Our chief operating decision-maker reviews financial information presented on a consolidated basis, accompanied by separate information about operating results by geographic region for purposes of making operating decisions and assessing financial performance.

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

	Three months ended March 31,		Nine months ended March 31,	
	2006	2005	2006	2005
<b>Total Revenue:</b>				
North America	\$ 2,518	\$ 2,543	\$ 8,182	\$ 7,605
Europe	3,530	1,956	8,730	6,570
Asia Pacific	86	179	454	411
	\$ 6,134	\$ 4,678	\$ 17,366	\$ 14,586
<b>Operating Income (Loss):</b>				
North America	\$ (500)	\$ (33)	\$ (570)	\$ 831
Europe	1,234	(29)	2,512	765
Asia Pacific*	(412)	(413)	(1,046)	(1,388)
	\$ 322	\$ (475)	\$ 896	\$ 208

\* Includes costs associated with corporate support.

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

	March 31,	
	2006	2005
North America	\$ 5,936	\$ 6,489
Europe	5,702	2,913
Asia Pacific	713	926
	\$ 12,351	\$ 10,328

The following table provides the revenue for the three and nine months ended March 31, 2006 and 2005 (in thousands):

	Three months ended March 31,		Nine months ended March 31,	
	2006	2005	2006	2005
<b>Revenue :</b>				
License	\$ 1,859	\$ 1,071	\$ 5,249	\$ 3,727
Hosting services	948	851	2,635	2,658
Maint & Support services	2,120	2,047	6,274	5,989
Professional services	1,207	709	3,208	2,211
	\$ 6,134	\$ 4,678	\$ 17,366	\$ 14,585

During the three months ended March 31, 2006, there was one customer that accounted for 23% of total revenue and there were no customers that accounted for more than 10% of total revenue in the comparable year-ago quarter. For the nine months ended March 31, 2006 and 2005, there were no customers that accounted for more than 10% of total revenue.

**Note 7. Related Party Notes Payable**



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During fiscal year 2003, we entered into a note and warrant purchase agreement with Ashutosh Roy, our Chief Executive Officer, pursuant to which Mr. Roy made loans to us evidenced by one or more subordinated secured promissory notes and received warrants to purchase shares of our common stock in connection with each of such loans. The five year subordinated secured promissory note bears interest at an effective annual rate of 12% due and payable upon the term of such note. We have the option to prepay each note at any time subject to the prepayment penalties set forth in such note. On December 31, 2002, Mr. Roy loaned to us \$2.0 million under the agreement and received warrants that allow him to purchase up to 236,742 shares at an exercise price equal to \$2.11 per share. These warrants expired on December 23, 2005. On October 31, 2003, we entered into an amendment to the 2002 note and warrant purchase agreement with Mr. Roy, pursuant to which he loaned to us an additional \$2.0 million and received additional warrants to purchase up to

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128,766 shares at \$3.88 per share. The principal and interest due on the loans as of March 31, 2006 was \$5.4 million. As of March 31, 2006, warrants to purchase 128,766 shares of common stock were vested and outstanding.

On March 31, 2004, we entered into a note and warrant purchase agreement with Ashutosh Roy, our Chief Executive Officer, Oak Hill Capital Partners L.P., Oak Hill Capital Management Partners L.P., and FW Investors L.P. (the lenders) pursuant to which the lenders loaned to us \$2.5 million evidenced by secured promissory notes and received warrants to purchase shares of our common stock in connection with such loans. The secured promissory notes have a term of five years and bear interest at an effective annual rate of 12% due and payable upon the maturity of such notes. We have the option to prepay the notes at any time subject to the prepayment penalties set forth in such notes. The warrants allow the lenders to purchase up to 312,500 shares at an exercise price of \$2.00. The principal and interest due on the loans as of March 31, 2006 was \$3.0 million. As of March 31, 2006, warrants to purchase 312,500 shares of common stock were vested and outstanding.

**Note 8. Bank Borrowings**

On October 29, 2004, we entered into a new loan and security agreement (the Credit Facility) with Silicon Valley Bank (SVB) which replaced the existing accounts receivable purchase agreement. The Credit Facility provided for the advance of up to the lesser of \$1.5 million or 80% of certain qualified receivables. The Credit Facility bears interest at a rate of prime plus 2.5% per annum, provided that if we maintain an adjusted quick ratio of greater than 2 : 1, then the rate shall be reduced to a rate of prime plus 1.75%. In addition, the Credit Facility carries a \$750 per month collateral monitoring fee. We are in compliance with the financial covenants under this agreement that require us to meet certain rolling three-month operating losses during the term of the Credit Facility. On December 28, 2004, we entered into an amendment to the Credit Facility that revised the terms to allow for the advance of up to the lesser of \$1.5 million or the sum of 80% of certain qualified receivables and 50% of our unrestricted cash on deposit with SVB less the total outstanding obligations to SVB and any outstanding letters of credit. As of March 31, 2006, the interest rate was 10.25%, and the outstanding balance under the Credit Facility was \$1.2 million. On March 29, 2005, we entered into a further amendment to the Credit Facility that revised the terms to allow for the advance of up to an additional \$750,000 to be used to finance equipment purchases (the Equipment Line). Interest accrues from the date of each advance, under the Equipment Line, at a rate of prime plus 3% per annum. Each advance under the Equipment Line must be repaid in 24 equal monthly payments of principal and interest, commencing on the first day of the first month following the date the advance is made, and continuing on the first day of each succeeding month. On January 27, 2006 we entered into an extension of our Credit Facility with Silicon Valley Bank. The amendment extended the termination date to July 28, 2006 and the advance level under the Equipment Line was modified not to exceed \$124,165, plus the unpaid principal balance of the Equipment Advances outstanding as of January 25, 2006. As of March 31, 2006, the interest rate was 10.25% and the outstanding balance under the Equipment Line was approximately \$286,000.

**Note 9. Restructuring****Background**

Beginning in fiscal 2001 and continuing through the first quarter of fiscal 2004, economic conditions in North America and many of the other countries in which we operate either deteriorated or stabilized at depressed levels. This continuing weak economic environment, and in particular spending in technology, has had an adverse impact on sales of enterprise software. As a result, we saw a decline in our revenues from fiscal 2001 to fiscal 2004. In response to this decline, we initiated a series of steps to streamline operations and better align operating costs and expenses with revenue trends. Specifically, we took the following actions:

We reduced the discretionary portion of our operating costs through various cost control initiatives, including: (i) reducing marketing expenditures; (ii) movement of certain key business functions from North America to India; (iii) temporary reduction in salaries (fiscal 2002) in North America and Europe; (iv) eliminating the majority of bonuses or realigning bonuses more closely with achievement of financial objectives; (v) reducing depreciation, primarily through reduced capital expenditures; and (vi) reducing other discretionary expenditures, such as costs related to outside consultants, travel and recruiting.

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Based on our continued evaluation of economic conditions and a continued decline in our revenues we initiated a further restructuring of our operations in fiscal 2002. The Plan consisted primarily of the consolidation of excess facilities, the abandonment of certain assets in connection with the consolidation of excess facilities and further reductions in our workforce.

Based on our continued evaluation of economic conditions and a continued decline in our revenues we initiated a further restructuring of our operations in the first fiscal quarter of 2004. The Plan consisted of further reductions in our workforce in Europe.

Based upon our evaluation of the performance of our Japan operations we initiated a restructuring plan in January 2005 to close the Japan office.

As part of separate settlement agreements with the two landlords, in the event we made a distribution of cash, stock or other consideration to holders of our Series A Preferred with respect to the shares of Series A Preferred, each of the two landlords would receive a payment equal to the lesser of (i) \$1.0 million or (ii) the amount payable to a holder of shares of Series A Preferred with an aggregate stated value of \$1.0 million. Based upon the final distribution to the preferred stock holders we reduced the outstanding liability we had accrued for these two settlements by approximately \$958,000. In February 2005, a total payment of \$242,000 was made for the finalized settlements and the over accrual of \$46,000 was reversed.

During the three and nine months ended March 31, 2006, we recorded no restructuring expense and the restructuring accrual was paid in full.

### **Note 10. Commitments**

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

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

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

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

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*. This new standard replaces APB Opinion No. 20, *Accounting Changes in Interim Financial Statements*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and represents another step in the FASB's goal to converge its standards with those issued by the International Accounting Standards Board (IASB). Among other changes, SFAS 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle unless it is impracticable. SFAS 154 also provides that (1) a change in method of depreciating or amortizing a long-lived non-financial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be termed a restatement. The new standard is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. Early adoption of this standard is permitted for accounting changes and correction of errors made in fiscal years beginning after June 1, 2005. We do not expect the adoption of SFAS 154 to have a material effect on our consolidated financial statements.

**Table of Contents****Note 12. Litigation**

Beginning on October 25, 2001, a number of securities class action complaints were filed against us, and certain of our then officers and directors and underwriters connected with our initial public offering of common stock in the U.S. District Court for the Southern District of New York (*consolidated into In re Initial Public Offering Sec. Litig.*). The complaints alleged generally that the prospectus under which such securities were sold contained false and misleading statements with respect to discounts and excess commissions received by the underwriters as well as allegations of "laddering" whereby underwriters required their customers to purchase additional shares in the aftermarket in exchange for an allocation of IPO shares. The complaints sought an unspecified amount in damages on behalf of persons who purchased the common stock between September 23, 1999 and December 6, 2000. Similar complaints were filed against 55 underwriters and more than 300 other companies and other individuals. The over 1,000 complaints were consolidated into a single action. We reached an agreement with the plaintiffs to resolve the cases as to our liability and that of our officers and directors. The settlement involved no monetary payment or other consideration by us or our officers and directors and no admission of liability. On August 31, 2005, the court issued an order preliminarily approving the settlement and setting a public hearing on its fairness for April 24, 2006 (the postponement from January 2006 to April 2006 was because of difficulties in mailing the required notice to class members). On October 27, 2005, the court issued an order making some minor changes to the form of notice to be sent to class members. On January 17, 2006, the court issued an order modifying the preliminary settlement approval order to extend the time within which notice must be given to the class, which time had expired on January 15, 2006. The underwriter defendants filed further objections to the settlement on March 20, 2006 and asked that the April 24, 2006 final settlement approval hearing be postponed until after the Second Circuit rules on the underwriters' appeal from the Court's class certification order (which appeal is briefed and awaiting oral argument). On March 29, 2006, the Court denied the request, stating that it would address the underwriters' points at the April 24, 2006 hearing. On April 24, 2006, the Court held a public hearing on the fairness of the proposed settlement. The Court took the matter under submission and has not yet ruled.

On February 12, 2004, we filed suit against Insight Enterprises, Inc., the acquirer of Comark, Inc., a value-added reseller of our software, claiming *inter alia* breach of contract and failure to pay in connection with a sale of our software to one customer in the Superior Court of the State of California, Santa Clara County. The lawsuit seeks in excess of \$600,000 in damages.

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

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

*This report on Form 10-Q and the documents incorporated herein by reference contain forward-looking statements that involve risks and uncertainties. These statements may be identified by the use of the words such as anticipates, believes, continue, could, would, estimates, forecasts, expects, intends, may, might, plans, potential, predicts, should, or will and similar expressions or the negative of those terms. The forward-looking statements include, but are not limited to, risks stemming from strategic and operational choices in recent quarters, failure to improve our sales results and grow revenue, failure to compete successfully in the markets in which we do business, our history of net losses and our ability to sustain profitability, our limited operating history, the adequacy of our capital resources and need for additional financing, continued lengthy and delayed sales cycles, the development of our strategic relationships and third party distribution channels, broad economic and political instability around the world affecting the market for our goods and services, the continued need for customer service and contact center software solutions and the continued acceptance of our Web-native architecture, our ability to respond to rapid technological change and competitive challenges, the effects of cost reductions on our workforce and ability to service customers, risks from our substantial international operations, adverse results in pending litigation, legal and regulatory uncertainties and other risks related to protection of our intellectual property assets and the operational integrity and maintenance of our systems. Our actual results could differ materially from those discussed in statements relating to our future plans, product releases, objectives, expectations and intentions, and other assumptions underlying or relating to any of these statements. Factors that could contribute to such differences include those discussed in Factors That May Affect Future Results and elsewhere in this document. These forward-looking statements speak only as of the date hereof. We expressly disclaim any obligation or understanding to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.*

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### **Overview**

We build, sell, and deploy customer interaction hub software solutions for enterprises and mid-sized businesses. Our solutions help businesses transform their call centers to multi-channel customer interaction hubs to deliver differentiated service while maintaining costs. We believe the customer interaction hub market presents a growing opportunity worldwide as the total number of customer interactions is growing geometrically as consumer choice increases and products become more complex. Consumers are demanding consistent, high-quality service from businesses across all channels - web, phone, email, print, and in-person. In response, businesses are looking to invest in effective front-end and efficient back-end customer interaction processes within a customer interaction hub. In a customer interaction hub, interactions across all channels - web, phone, email, print, or in-person - are handled with the same service delivery infrastructure - with common queues for work allocation, best-practice business processes, unified knowledge bases, and aggregated customer history.

We are a focused leader in the customer interaction hub space with proven customer successes and sustained product leadership. Our success is defined by the business value our customers derive from our solutions. eGain Service 7 , our software suite, available through licensed or hosted models, includes integrated, best-in-class applications for customer email management, live web collaboration, virtual agent customer service, knowledge management, and web self-service. These robust applications are built on the eGain Service Management Platform (eGain SMP ), a scalable framework that includes end-to-end service process management, multi-channel, multi-site contact center management, a flexible integration approach, and certified out-of-the-box integrations with leading call center and business systems.

### **Critical Accounting Policies and Estimates**

Management's Discussion and Analysis of Financial Condition and Results of Operations discusses our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, management evaluates its estimates and judgments, including those related to revenue recognition, valuation allowances and accrued liabilities, long-lived assets and stock-based compensation. Management bases its estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

#### *Stock-Based Compensation*

We adopted Statement of Financial Accounting Standards ( SFAS ) No. 123 (revised 2004), *Share-Based Payment*, effective July 1, 2005. SFAS 123R is a new and very complex accounting standard, the application of which requires significant judgment and the use of estimates, particularly surrounding Black-Scholes assumptions such as stock price volatility and expected option lives, as well as expected option forfeiture rates to value equity-based compensation. SFAS 123R also requires that the benefit of tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. This tax difference for unexercised options must also be recorded as a deferred tax item and recorded in additional paid in capital. We cannot estimate what those amounts will be in the future

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(because they depend on, among other things, when employees exercise stock options). Refer to Note 3 Stock-Based Compensation in our notes to our unaudited condensed consolidated financial statements included elsewhere in this quarterly report on Form 10-Q for more discussion.

### *Revenue Recognition*

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

We apply the provisions of Statement of Position ( SOP ) 97-2, *Software Revenue Recognition*, as amended by SOP 98-9 *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions* to all transactions involving the licensing of software products. In the event of a multiple element arrangement we evaluate the transaction as if each element represents a separate unit of accounting taking into account all factors following the guidelines set forth in Emerging Issues Task Force Issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*, ( EITF 00-21 ). For fixed fee arrangements the services revenues are recognized in accordance with the provisions of SOP 81-1, *Accounting for Performance of Construction Type and Certain Production Type Contracts*, when reliable estimates are available for the costs and efforts necessary to complete the implementation services. When such estimates are not available, the completed contract method is utilized.

When licenses are sold together with system implementation and consulting services, license fees are recognized upon shipment, provided that (i) payment of the license fees is not dependent upon the performance of the consulting and implementation services, (ii) the services are available from other vendors, (iii) the services qualify for separate accounting as we have sufficient experience in providing such services and we have vendor specific objective evidence of pricing, and (iv) the services are not essential to the functionality of the software. For arrangements that do not meet the above criteria, both the product license revenues and the service revenues are recognized under the percentage of completion method. This has not been necessary in the last three years.

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

### *License Revenue*

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

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

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We periodically sell to resellers. Revenue from sales to resellers is recognized either upon delivery to the reseller or on a sell-through basis depending on the facts and circumstances of the transaction, such as our understanding of the reseller's plans to sell the software, if there are any return provisions, price protection or other allowances, the reseller's financial status and our past experience with the particular reseller. Historically sales to resellers have not included any return provisions, price protections or other allowances.

### *Professional Services Revenue*

Included in support services revenues are revenues derived from system implementation, consulting and training. The majority of our consulting and implementation services and accompanying agreements qualify for separate accounting. For hosting implementation services that do not qualify for separate accounting, we recognize the services revenue ratably over the remaining term of the hosting agreement. We use vendor specific objective evidence of fair value for the services and maintenance to account for the arrangement using the residual method, regardless of any separate prices stated within the contract for each element. Our consulting and implementation service contracts are bid either on a fixed-fee basis or on a time-and-materials basis. Substantially all of our contracts are on a time-and-materials basis. For time-and-materials contracts, we recognize revenue as services are performed. For a fixed-fee contract, we recognize revenue based upon the costs and efforts to complete the services in accordance with the percentage of completion method.

Training revenue is recognized when training is provided.

### *Hosting Services Revenue*

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

We evaluate whether each of the elements in these arrangements represents a separate unit of accounting, as defined by EITF 00-21, using all applicable facts and circumstances, including whether (i) we sell or could readily sell the element unaccompanied by the other elements, (ii) the element has stand-alone value to the customer, (iii) there is objective reliable evidence of the fair value of the undelivered item, and (iv) there is a general right of return.

We allocate the arrangement consideration to the separate units of accounting based on their relative fair values, as determined by the price of the undelivered items when sold separately. Assuming all other criteria are met (i.e., evidence of an arrangement exists, collectibility is probable, and fees are fixed or determinable), revenue is recognized as follows:

Hosting services are recognized ratably over the term of the initial hosting contract;

Professional services are recognized as described above under Professional Services Revenue ; and

License revenue is recognized as described above under License Revenue.

We consider the applicability of EITF 00-03 on a contract-by-contract basis. In hosted term-based agreements, where the customer does not have the contractual right to take possession of the software, the revenue is recognized on a monthly basis over the term of the contract. Amounts that have been invoiced are recorded in accounts receivable and in deferred revenue or revenue, depending on whether the revenue recognition criteria have been met. If we determine that the customer has the contractual right to take possession of our software at any time during the hosting period without significant penalty, and can feasibly run the software on its own hardware or enter into another arrangement with a third party to host the software, a software element covered by SOP 97-2 exists. When a software element exists in a hosting services arrangement, we recognize the license, professional services and hosting services revenues pursuant to SOP 97-2, whereby the fair value of the hosting service is recognized as revenue ratably over the term of the hosting contract. We have established vendor specific objective evidence for

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the hosting and support elements of perpetual license sales, based on the prices charged when sold separately and substantive renewal terms. Accordingly, revenue for the perpetual software license element is determined using the residual method and is recognized upon delivery. Revenue for the hosting and support elements is recognized ratably over the contractual time period.

If evidence of fair value cannot be established for the undelivered elements of an agreement, the entire amount of revenue from the arrangement is recognized ratably over the period that these elements are delivered. For implementation services that we determine do not have stand-alone value to the customer, we recognize the services revenue ratably over the remaining term of the hosting agreement.

### *Maintenance and Support Revenue*

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

### *Valuation of Goodwill*

We review goodwill annually for impairment (or more frequently if impairment indicators arise). We performed an annual goodwill impairment review at June 30 every year and we found no impairment on June 30, 2005. Additionally, we did not identify any indicators which made us believe goodwill was potentially impaired during the quarter ended March 31, 2006.

### *Allowance for Doubtful Accounts*

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



**Table of Contents****Results of Operations**

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

	Three Months March 31,		Six Months March 31,	
	2006	2005	2006	2005
<b>Revenue:</b>				
License	30%	23%	30%	26%
Support and Services	70%	77%	70%	74%
Total revenue	100%	100%	100%	100%
<b>Cost of license</b>				
Cost of license	0%	1%	1%	2%
<b>Cost of support and services</b>				
Cost of support and services	30%	34%	30%	31%
Gross profit	70%	65%	69%	67%
<b>Operating costs and expenses:</b>				
Research and development	13%	12%	13%	11%
Sales and marketing	42%	45%	40%	44%
General and administrative	10%	18%	11%	17%
Restructuring and other	0%	0%	0%	(6)%
Total operating costs and expenses	65%	75%	64%	66%
Income from operations	5%	(10)%	5%	1%

**Revenues**

Total revenue increased 31% to \$6.1 million in the quarter ended March 31, 2006 from \$4.7 million in the quarter ended March 31, 2005. Total revenue for the nine months ended March 31, 2006 increased 19% to \$17.4 million, compared to \$14.6 million in the same period last year. The increase was primarily due to the increase in license and professional services revenue. During the three months ended March 31, 2006, there was one customer that accounted for 23% of total revenue, no one customer accounted for more than 10% of total revenue in the comparable year-ago quarter. For the nine months ended March 31, 2006 and 2005, there were no customers that accounted for more than 10% of total revenue.

Based upon current sales activities we anticipate total revenue to increase over the next fiscal year. We are seeing increased interest from medium to large-sized companies in our customer interaction solutions. There is however general unpredictability of the length of our current sales cycles and seasonal buying patterns. In addition, sales to these larger companies are generally more complex and time consuming, with new customers often choosing to make smaller initial purchases to be followed up with additional purchases if the product meets with their business requirements. Also, because we offer a hybrid delivery model, the mix of new hosting and license business in a quarter could also have an impact on our revenue in a particular quarter. For license transactions the license revenue amount is generally recognized in the quarter delivery and acceptance of our software takes place whereas, for hosting transactions, hosting revenue is recognized ratably over the term of the hosting contract, which is typically one to two years. As a result, our total revenue may increase or decrease in future quarters as a result of the timing and mix of license transactions.

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(in thousands)	Three Months				Nine months			
	2006	March 31,	Change	%	2006	March 31,	Change	%
		2005				2005		
<b>Revenue:</b>								
License	\$ 1,859	\$ 1,071	\$ 788	74%	\$ 5,249	\$ 3,728	\$ 1,521	41%
Percentage of total revenue	30%	23%			30%	26%		

License revenue increased 74% to \$1.9 million in the quarter ended March 31, 2006 from \$1.1 million in the quarter ended March 31, 2005. License revenue for the nine months ended March 31, 2006 increased 41% to \$5.2 million, compared to \$3.7 million in the same period last year. The increase was primarily due to one license transaction in the quarter that accounted for approximately 22% of total revenue for the quarter. This transaction was a follow on sale to an existing customer purchasing additional licenses for previously purchased products. License revenue represented 30% and 23% of total revenue for the quarters ended March 31, 2006 and 2005, respectively. License revenue represented 30% and 26% of total revenue for the nine months ended March 31, 2006 and 2005, respectively. Given the general unpredictability of the length of current sales cycles, license revenue may increase or decrease in future quarters as a result of the timing of license transactions being completed, but we anticipate license revenues to increase over the future quarters.

Support and Services

(in thousands)	Three Months				Nine months			
	2006	March 31,	Change	%	2006	March 31,	Change	%
		2005				2005		
<b>Revenue:</b>								
Hosting services	\$ 948	\$ 851	\$ 97	11%	\$ 2,635	\$ 2,658	\$ (23)	(0)%
Maint. and support services	\$ 2,120	\$ 2,047	\$ 73	4%	\$ 6,274	\$ 5,989	\$ 285	5%
Professional services	\$ 1,207	\$ 709	\$ 498	70%	\$ 3,208	\$ 2,211	\$ 997	45%
<b>Total support and services</b>	<b>\$ 4,275</b>	<b>\$ 3,607</b>	<b>\$ 668</b>	<b>19%</b>	<b>\$ 12,117</b>	<b>\$ 10,858</b>	<b>\$ 1,259</b>	<b>12%</b>
Percentage of total revenue	70%	77%			70%	74%		

Support and services includes hosting, software maintenance and support and professional services. Maintenance and support consists of technical support and software upgrades and enhancements. Professional services primarily consist of consulting and implementation services and training. Support and services revenue increased 19% to \$4.3 million in the quarter ended March 31, 2006 from \$3.6 million in the quarter ended March 31, 2005. Support and services for the nine months ended March 31, 2006 increased 12% to \$12.1 million, compared to \$10.9 million in the same period last year. The increase was primarily due to the increase in professional services. Support and services revenue represented 70% and 77% of total revenue for the quarters ended March 31, 2006 and 2005, respectively. Support and services revenue represented 70% and 74% of total revenue for the nine months ended March 31, 2006 and 2005, respectively.

Hosting revenue increased 11% to \$948,000 in the quarter ended March 31, 2006 from \$851,000 in the quarter ended March 31, 2005. Hosting services for the nine months ended March 31, 2006 was \$2.6 million, compared to \$2.7 million in the same period last year. Hosting revenue increased 12% sequentially in the quarter ended March 31, 2006 and we expect hosting revenue to increase in future periods based upon current renewal rates for existing hosted customers and the new hosting agreements entered into in recent quarters that we expect to start generating hosting revenue in future quarters.

Maintenance and support revenue increased 4% to \$2.1 million in the quarter ended March 31, 2006 from \$2.0 million in the quarter ended March 31, 2005. Maintenance and support revenue for the nine months ended March 31, 2006 increased 5% to \$6.3 million, compared to \$6.0 million in the same period last year. The increase was primarily due to the increase in license revenue. We expect maintenance and support revenue to increase in future periods based upon current renewal rates and the increase in license revenue in recent quarters.

Professional services revenue increased 70% to \$1.2 million in the quarter ended March 31, 2006 from \$709,000 in the quarter ended March 31, 2005. Professional services revenue for the nine months ended March 31, 2006 increased 45% to \$3.2 million, compared to \$2.2 million in the

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same period last year. The increase was primarily due to the increase in the size of professional services engagements with larger companies deploying our

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customer interaction solutions within their organizations. Based upon our current sales pipeline we expect professional services revenue to increase slightly in future periods.

**Cost of Revenues**

(in thousands)	Three Months				Nine Months			
	2006	March 31,		%	2006	March 31,		%
		2005	Change			2005	Change	
Cost of Revenues	\$ 1,857	\$ 1,626	\$ 231	14%	\$ 5,345	\$ 4,842	\$ 503	10%
Percentage of total revenue	30%	35%			31%	33%		

Total cost of revenue increased 14% to \$1.9 million in the quarter ended March 31, 2006 from \$1.6 million in the quarter ended March 31, 2005. Total cost of revenue for the nine months ended March 31, 2006 increased 10% to \$5.3 million, compared to \$4.8 million in the same period last year. The increase was primarily due to the increased personnel costs associated with the increase in professional services revenues. Total cost of revenue represented 30% and 35% of total revenues in the quarter ended March 31, 2006 and 2005. The reduction in the cost of revenue as a percentage of total revenue for the quarter ended March 31, 2006 was primarily due to the increase of license revenue as a percentage of total revenue when compared to the quarter ended March 31, 2005. Total cost of revenue represented 31% and 33% of total revenues for the nine months ended March 31, 2006 and 2005.

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

**Cost of License**

(in thousands)	Three Months				Nine Months			
	2006	March 31,		%	2006	March 31,		%
		2005	Change			2005	Change	
Cost of License	\$ 29	\$ 57	\$ (28)	(49)%	\$ 215	\$ 306	(91)	(30)%
Percentage of license revenue	2%	5%			4%	8%		
Gross Margin	98%	95%			96%	92%		

Cost of license primarily includes third-party software royalties and delivery costs for shipments to customers. Total cost of license decreased 49% to \$29,000 in the quarter ended March 31, 2006 from \$57,000 in the quarter ended March 31, 2005. The decrease was primarily due to the one of the royalty agreements was fully-amortized in the quarter ended March 31, 2006. Total cost of license for the nine months ended March 31, 2006 decreased 30% to \$215,000, compared to \$306,000 in the same period last year. Total cost of license decreased as a percentage of total license revenues to 2% (a gross margin of 98%) in the quarter ended March 31, 2006 from 5% (a gross margin of 95%) in the quarter ended March 31, 2005. The decrease in cost of license for the nine months ended March 31, 2006 when compared to the nine months ended March 31, 2005 was primarily due to the expiration and renegotiation of certain royalty agreements that resulted in a reduction in the amortization of prepaid royalties. In addition, as part of our ongoing product development strategy, eGain Service 7 has less third-party software built into it than prior product releases and therefore lower corresponding third-party software royalty costs. Total cost of license decreased as a percentage of total license revenues to 4% (a gross margin of 96%) for the nine months ended March 31, 2006 from 8% (a gross margin of 92%) for the nine months ended March 31, 2005. We anticipate cost of license as a percentage of revenue to remain relatively constant in future periods, but to increase or decrease in absolute dollars based upon the increase or decrease in our license revenue in future periods.

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

(in thousands)

	<b>March 31,</b>				<b>Nine Months March 31,</b>			
	<b>2006</b>	<b>2005</b>	<b>Change</b>	<b>%</b>	<b>2006</b>	<b>2005</b>	<b>Change</b>	<b>%</b>
<b>Cost of support and service</b>	\$ 1,828	\$ 1,569	\$ 259	17%	\$ 5,130	\$ 4,536	594	13%
Percentage of support and service revenue	43%	43%			42%	42%		
Gross Margin	57%	57%			58%	58%		

Cost of support and services includes personnel costs for our hosting services, consulting services and customer support. It also includes depreciation of capital equipment used in our hosted network, cost of support for the third-party software and lease costs paid to remote co-location centers. Total cost of support and services increased 17% to \$1.8 million in the quarter ended March 31, 2006 from \$1.6 million in the quarter ended March 31, 2005. Total cost of support and services for the nine months ended March 31, 2006 increased 13% to \$5.1 million, from \$4.5 million in the same period last year. The increase was primarily due to increased personnel costs associated with delivering the increased professional services engagements. Total cost of support and services as a percentage of total support and services revenues was 43% (a gross margin of 57%) in the quarter ended March 31, 2006 unchanged from the quarter ended March 31, 2005. Total cost of support and services as a percentage of total support and services revenues was 42% (a gross margin of 58%) for the nine months ended December 31, 2005 unchanged from the same period last year. Based upon current revenue expectations, we anticipate cost of support and services to increase in absolute dollars in future periods but for the gross margins to remain relatively constant in future periods.

**Research and Development****Three Months****Nine Months**

(in thousands)

	<b>March 31,</b>				<b>March 31,</b>			
	<b>2006</b>	<b>2005</b>	<b>Change</b>	<b>%</b>	<b>2006</b>	<b>2005</b>	<b>Change</b>	<b>%</b>
<b>Research and Development</b>	\$ 782	\$ 571	\$ 211	37%	\$ 2,199	\$ 1,633	\$ 566	35%
Percentage of total revenue	13%	12%			13%	11%		

Research and development expenses primarily consist of compensation and benefits for our engineering, product management and quality assurance personnel and, to a lesser extent, occupancy costs and related overhead. Our product development focus in fiscal year 2005 and continuing in fiscal year 2006 is in bringing additional products onto the core Service Management Platform (eGain SMP). Leveraging our open Java J2EE architecture, we have also expanded our reach with support for additional operating systems and database platforms. Research and development costs increased 37% to \$782,000 in the quarter ended March 31, 2006 from \$571,000 in the quarter ended March 31, 2005. Total research and development costs for the nine months ended March 31, 2006 increased 35% to \$2.2 million, from \$1.6 million in the same period last year. The increase is primarily due to increased personnel costs. Total research and development expenses as a percentage of total revenues was 13% in the quarter ended March 31, 2006 compared to 12% in the quarter ended March 31, 2005. Total research and development expenses as a percentage of total revenues was 13% for the nine months ended March 31, 2006 compared to 11% in the same period last year. Based upon current revenue expectations and increased personnel costs associated with annual salary adjustments for our eGain India employees that are effective April 1, 2006, we anticipate an increase in research and development expense in future periods.

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

(in thousands)	Three Months				Nine Months			
	2006	March 31, 2005	Change	%	2006	March 31, 2005	Change	%
	<b>Sales</b>	\$ 2,146	\$ 1,680	\$ 466	28%	\$ 5,666	\$ 5,056	\$ 610
<b>Marketing</b>	\$ 442	\$ 447	\$ (5)	(1)%	\$ 1,307	\$ 1,378	\$ (71)	(5)%
<b>Total Sales and Marketing</b>	\$ 2,588	\$ 2,127	\$ 461	22%	\$ 6,973	\$ 6,434	\$ 539	8%
Percentage of total revenue	42%	45%			40%	44%		

Sales and marketing expenses primarily consist of compensation and benefits for our sales, marketing and business development personnel, lead generation activities, advertising, trade show and other promotional costs and, to a lesser extent, occupancy costs and related overhead. Sales and marketing expense increased 22% to \$2.6 million in the quarter ended March 31, 2006 from \$2.1 million in the quarter ended March 31, 2005.

Total Sales and marketing expense for the nine months ended March 31, 2006 increased 8% to \$7.0 million from \$6.4 million in the same period last year. Total sales and marketing expenses as a percentage of total revenues was 42% in the quarter ended March 31, 2006 compared to 45% in the quarter ended March 31, 2005. Total sales and marketing expenses as a percentage of total revenues was 40% for the nine months ended March 31, 2006 compared to 44% in the same period last year.

Total sales expenses increased 28% to \$2.1 million in the quarter ended March 31, 2006 from \$1.7 million in the quarter ended March 31, 2005. Total sales expenses for the nine months ended March 31, 2006 increased 12% to \$5.7 million, from \$5.1 million in the same period last year. The increase was primarily due to increased personnel costs related to hiring in North America and Europe and increased sales commissions associated with the increased total revenue. The increase was partially offset by the reduced expenses resulting from the closure of our Japanese office in fiscal year 2005. Sales costs for the Japanese office totaled approximately \$90,000 and \$330,000 for the three and nine months ended March 31, 2005, respectively.

Total marketing expenses decreased 1% to \$442,000 in the quarter ended March 31, 2006 from \$447,000 in the quarter ended March 31, 2005. Total marketing expenses for the nine months ended March 31, 2006 decreased 5% to \$1.3 million from \$1.4 million in the same period last year.

We expect sales and marketing expenses to increase in future periods as we plan to increase the size of our sales team and expand our marketing activities in an effort to increase revenues.

**General and Administrative**

(in thousands)	Three Months				Nine Months			
	2006	March 31, 2005	Change	%	2006	March 31, 2005	Change	%
	<b>General and Administrative</b>	\$ 585	\$ 815	\$ (230)	(28)%	\$ 1,953	\$ 2,413	\$ (460)
Percentage of total revenue	10%	17%			11%	17%		

General and administrative expenses primarily consist of compensation and benefits for our finance, human resources, administrative and legal services personnel, fees for outside professional services, provision for doubtful accounts and, to a lesser extent, occupancy costs and related overhead. General and administrative expense decreased 28% to \$585,000 in the quarter ended March 31, 2006 from \$815,000 in the quarter ended March 31, 2005. Total general and administrative expenses as a percentage of total revenues was 10% in the quarter ended March 31, 2006 compared to 17% in the quarter ended March 31, 2005. The decrease was primarily due to reduced personnel expenses of approximately \$140,000, reduced bad debt expense of approximately \$50,000 and reduced insurance premiums of approximately \$40,000. Total general and administrative expenses for the nine months ended March 31, 2006 decreased 19% to \$2.0 million, from \$2.4 million in the same period last year. Total general and administrative expenses as a percentage of total revenues was 11% for the nine months ended March 31, 2006 compared to 17% for the nine months ended March 31, 2005. The decrease was primarily due to reduced personnel expenses of approximately \$300,000, reduced legal fees of approximately \$100,000, and reduced insurance premiums of approximately \$100,000, partially offset by increased stock based compensation expense of \$83,000. Based upon current revenue expectations, we do not anticipate a significant increase or decrease in general and administrative expenses in future periods.



**Table of Contents****Stock-Based Compensation**

(in thousands)	Three Months				Nine Months			
	March 31,				March 31,			
	2006	2005	Change	%	2006	2005	Change	%
Cost of support and services	\$ 7		NM	NM	\$ 27		NM	NM
Research and development	9		NM	NM	39		NM	NM
Sales and marketing	27		NM	NM	64		NM	NM
General and administrative	19		NM	NM	83		NM	NM
<b>Total Stock-Based Compensation</b>	<b>\$ 62</b>		<b>NM</b>	<b>NM</b>	<b>\$ 213</b>		<b>NM</b>	<b>NM</b>
Percentage of total revenue	1%	NM	NM	NM	1%	NM	NM	NM

Stock compensation expenses include the amortization of the fair value of share-based payments made to employees, Board of Directors and consultants, primarily in the form of stock options as we adopted the provision of SFAS 123R on July 1, 2005 (see Note 3 Stock-Based Compensation). The fair value of stock options granted is recognized as an expense as the underlying stock options vest.

We use the modified prospective method to value our share-based payments under SFAS 123R. Accordingly, for the three and nine months ended March 31, 2006, we accounted for stock compensation under SFAS 123R while for the three and six months ended March 31, 2005, we accounted for stock compensation under APB 25. Under APB 25, we were generally required to record compensation expense only if there were positive differences between the market value of our common stock and the exercise price of the options granted to employees as of the date of the grant. Under SFAS 123R, however, we record compensation expense for all share-based payments made to employees based on the fair value at the date of the grant. Therefore, stock compensation for the three and nine months ended March 31, 2006 is not comparable to the prior-year period.

Based upon recent and anticipated option grants, we do not expect our stock compensation expense to increase significantly in the three months ended June 30, 2006.

**Restructuring**

There was no restructuring expense for the three and nine months ended March 31, 2006. Restructuring expense was \$14,000 for the three months ended March 31, 2005 compared to a restructuring benefit of \$944,000 for the nine months ended March 31, 2005. The year-ago quarter restructuring benefit related to the accrual adjustment for the two outstanding lease settlements that had a final payment tied to the payment made to Series A Preferred holders.

**Income From Operations**

(in thousands)	Three Months				Nine Months			
	March 31,				March 31,			
	2006	2005	Change	%	2006	2005	Change	%
Operating Income / (Loss)	\$ 322	\$ (475)	\$ 797	168%	\$ 896	\$ 208	\$ 688	331%
Operating Margin	5%	(10)%			5%	1%		

Income from operations increased 168% to \$322,000 in the quarter ended March 31, 2006 from a loss of \$475,000 in the quarter ended March 31, 2005. Total income for the nine months ended March 31, 2006 increased 331% to \$896,000, from \$208,000 in the same period last year. The operating margin was 5% in the quarter ended March 31, 2006 period compared to a negative margin of 10% in the quarter ended March 31, 2005. For the nine months ended March 31, 2006, the operating margin was 5% compared to 1% in the same period a year ago.

**Interest Expense and Other Income / (Expenses)**

Interest expense increased 13% to \$283,000 in the quarter ended March 31, 2006 from \$250,000 in the quarter ended March 31, 2005. For the nine months ended March 31, 2006, interest expense increased 11% to \$827,000 from \$743,000 in the same period last year. The increase was primarily due to the increase in interest on borrowings from related party notes payable.





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Other income was \$49,000 in the quarter ended March 31, 2006 compared to other expense of \$0 in the quarter ended March 31, 2005. Other income primarily consisted of interest income and franchise tax refund. For the nine months ended March 31, 2006, other expense increased to \$33,000 from \$30,000 in the same period last year. Other expenses for the nine months ended March 31, 2006 and 2005 primarily consisted of tax expense and interest income.

**Liquidity and Capital Resources**

As of March 31, 2006, cash and cash equivalents totaled \$5.5 million, an increase of \$1.0 million from June 30, 2005. The increase was primarily due to the net cash provided by operating activities offset in part by net cash used in investing activities. We believe that existing capital resources will enable us to maintain current and planned operations for at least the next 12 months. From time to time, however, we may consider opportunities for raising additional capital and/or exchanging all or a portion of our existing debt for equity. We can make no assurances that such opportunities will be available to us on economic terms we consider favorable, if at all.

On October 29, 2004, we entered into a loan and security agreement (the Credit Facility ) with Silicon Valley Bank ( SVB ) which replaced the existing accounts receivable purchase agreement. The Credit Facility provided for the advance of up to the lesser of \$1.5 million or 80% of certain qualified receivables. The Credit Facility bears interest at a rate of prime plus 2.5% per annum, provided that if we maintain an adjusted quick ratio of greater than 2 : 1, then the rate shall be reduced to a rate of prime plus 1.75%. In addition, the Credit Facility carries a \$750 per month collateral monitoring fee. We are in compliance with the financial covenants under this agreement that require us to meet certain rolling three-month operating losses during the term of the Credit Facility. On December 28, 2004, we entered into an amendment to the Credit Facility that revised the terms to allow for the advance of up to the lesser of \$1.5 million or the sum of 80% of certain qualified receivables and 50% of our unrestricted cash on deposit with SVB less the total outstanding obligations to SVB and any outstanding letters of credit. As of March 31, 2006, the interest rate was 10.25%, and the outstanding balance under the Credit Facility was \$1.2 million. On March 29, 2005, we entered into a further amendment to the Credit Facility that revised the terms to allow for the advance of up to an additional \$750,000 to be used to finance equipment purchases (the Equipment Line ). Interest accrues from the date of each advance, under the Equipment Line, at a rate of prime plus 3% per annum. Each advance under the Equipment Line must be repaid in 24 equal monthly payments of principal and interest, commencing on the first day of the first month following the date the advance is made, and continuing on the first day of each succeeding month. As of March 31, 2006, the interest rate was 10.75% and the outstanding balance under the Equipment Line was approximately \$286,000. On January 27, 2006 we entered into an extension of our Credit Facility with Silicon Valley Bank. The amendment extended the termination date to July 28, 2006 and the advance level under the Equipment Line was modified not to exceed \$124,165, plus the unpaid principal balance of the Equipment Advances outstanding as of January 25, 2006. All other terms and conditions remained the same as outlined in Note 8.-Bank Borrowings in our notes to our unaudited condensed consolidated financial statements.

On March 31, 2004, we entered into a note and warrant purchase agreement with Ashutosh Roy, our Chief Executive Officer, Oak Hill Capital Partners L.P., Oak Hill Capital Management Partners L.P., and FW Investors L.P. (the lenders ) pursuant to which the lenders loaned to us \$2.5 million evidenced by secured promissory notes and received warrants to purchase shares of our common stock in connection with such loans. The secured promissory notes have a term of five years and bear interest at an effective annual rate of 12% due and payable upon the maturity of such notes. We have the option to prepay the notes at any time subject to the prepayment penalties set forth in such notes. The warrants allow the lenders to purchase up to 312,500 shares at an exercise price of \$2.00. The principal and interest due on the loans as of March 31, 2006 was \$3.0 million.

On December 24, 2002, we entered into a note and warrant purchase agreement with Ashutosh Roy, our Chief Executive Officer, pursuant to which Mr. Roy made loans to us evidenced by subordinated secured promissory notes and received warrants to purchase shares of our common stock in connection with each of such loans. The five-year subordinated secured promissory note bears interest at an effective annual rate of 12% due and payable upon the term of such note. We have the option to prepay each note at any time subject to the prepayment penalties set forth in such note. On December 31, 2002, Mr. Roy loaned to us \$2.0 million under the agreement and received warrants

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that allow him to purchase up to 236,742 shares at an exercise price equal to \$2.11 per share. On October, 31, 2003, we entered into an amendment to the 2002 note and warrant purchase agreement with Mr. Roy, pursuant to which he loaned to us an additional \$2.0 million and received additional warrants to purchase up to 128,766 shares at \$3.88 per share. The principal and interest due on the loans as of March 31, 2006 was \$5.4 million.

*Cash Flows*

Net cash provided by operating activities was \$1.8 million for the nine months ended March 31, 2006 and consisted primarily of net income plus non-cash expenses related to depreciation, stock-based compensation and accrued interest and amortization of discount on related party notes and the net change in operating assets and liabilities.

The net change in operating assets and liabilities primarily consisted of an increase in deferred revenue and a decrease in prepaid and other current assets partially offset by an increase in other assets and accounts receivable. The increase in deferred revenue was primarily due to increased deferred maintenance and support revenue associated with the increase in license revenue and the timing of payments received from customers renewing their maintenance and support contracts. The decrease in prepaid and other assets was primarily due to the reduction in the amortization of prepaid royalties resulting from the expiration of certain royalty agreements. The increase in accounts receivable was due to the increase in revenues partially offset by increased collection of accounts receivable in the quarter ended March 31, 2006 that resulted in a reduction of days sales outstanding to 68 days compared to 75 days for the quarter ended December 31, 2005.

Net cash used in operating activities was \$751,000 for the nine months ended March 31, 2005 and consisted primarily of net loss offset by non-cash expenses related to depreciation and accrued interest, partially offset by the net change in operating assets and liabilities. The net change in operating assets and liabilities primarily consisted of a decrease in restructuring accrual and an increase in accounts receivable partially offset by an increase in deferred revenue, a decrease in prepaid and other assets and an increase in accrued compensation. The decrease in accrued restructuring was due to the completion of two legal settlements that had payments tied to the distribution made in December 2004 to the holders of our Series A Preferred Stock. Based upon the final settlements, we recorded a restructuring benefit of \$958,00 in the quarter ended December 31, 2004, and a cash payment of \$242,000 and a final restructuring adjustment of \$46,000 in the quarter ended March 31, 2005 to bring this restructuring accrual to zero.

Continuing to operate a cash-positive business depends on our ability to achieve positive earnings and maintain or increase the level of our revenues, and continuing to effectively manage working capital including collecting outstanding receivables within our standard payment terms. In addition, our ability to generate future cash flows from operations could be negatively impacted by a decrease in demand for our products, which are subject to rapid technological change, or a reduction of capital expenditures by our customers as a result of a downturn in the global economy, among other factors.

Net cash used in investing activities was \$620,000 for the nine months ended March 31, 2006 compared to \$489,000 for the nine months ended March 31, 2005. Cash used in investing activities was due to the purchases of equipment.

Net cash used in financing activities was \$169,000 for the nine months ended March 31, 2006 compared to net cash provided by financing activities of \$1.1 million for the nine months ended March 31, 2005. Cash used in or provided from financing activities was primarily due to the proceeds from the bank borrowings and the issuance of common stock, partially offset by the payments on bank borrowings. The increase of net cash used in financing activities for the nine months ended March 31, 2006 was primarily due to the partial repayment of our bank borrowings in the quarter ended March 31, 2006.

*Commitments*

The following table summarizes eGain's contractual obligations, excluding interest payments, as of March 31, 2006 and the effect such obligations are expected to have on its liquidity and cash flow in future periods (in thousands):

	Year Ended June 30,						Total
	2006	2007	2008	2009	2010	Thereafter	
Operating leases	\$ 138	\$ 569	\$ 569	\$ 552	\$ 171	\$ 171	\$ 2,170
Bank borrowings	48	1,379	59				1,486
Related Party Note Payable			2,834	5,535			8,369
Total	\$ 186	\$ 1,948	\$ 3,462	\$ 6,087	\$ 171	\$ 171	\$ 12,025



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

We develop products in the United States and India and sell these products internationally. Generally, sales are made in local currency. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. To date, the effect of changes in foreign currency exchange rates on revenues and operating expenses has not been material. We do not currently use derivative instruments to hedge against foreign exchange risk.

### **Item 4. Controls and Procedures**

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

Based on their evaluation as of March 31, 2006, our Chief Executive Officer and Chief Financial Officer have concluded that, subject to the limitations noted above, our disclosure controls and procedures were effective to ensure that material information relating to us, including our consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which this Quarterly Report on Form 10-Q was being prepared.

(b) *Changes in internal controls.* There were no changes in our internal controls or, to our knowledge in other factors, that have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

Beginning on October 25, 2001, a number of securities class action complaints were filed against us, and certain of our then officers and directors and underwriters connected with our initial public offering of common stock in the U.S. District Court for the Southern District of New York (*consolidated into In re Initial Public Offering Sec. Litig.*). The complaints alleged generally that the prospectus under which such securities were sold contained false and misleading statements with respect to discounts and excess commissions received by the underwriters as well as allegations of "laddering" whereby underwriters required their customers to purchase additional shares in the aftermarket in exchange for an allocation of IPO shares. The complaints sought an unspecified amount in damages on behalf of persons who purchased the common stock between September 23, 1999 and December 6, 2000. Similar complaints were filed against 55 underwriters and more than 300 other companies and other individuals. The over 1,000 complaints were consolidated into a single action. We reached an agreement with the plaintiffs to resolve the cases as to our liability and that of our officers and directors. The settlement involved no monetary payment or other consideration by us or our officers and directors and no admission of liability. On August 31, 2005, the court issued an order preliminarily approving the settlement and setting a public hearing on its fairness for April 24, 2006 (the postponement from January 2006 to April 2006 was because of difficulties in mailing the required notice to class members). On October 27, 2005, the court issued an order making some minor changes to the form of notice to be sent to class members. On January 17, 2006, the court issued an order modifying the preliminary settlement approval order to extend the time within which notice must be given to the class, which time had expired on January 15, 2006. The underwriter defendants filed further objections to the settlement on March 20, 2006 and asked that the April 24, 2006 final settlement approval hearing be postponed until after the Second Circuit rules on the underwriters' appeal from the Court's class certification order (which appeal is briefed and awaiting oral argument). On March 29, 2006, the Court denied the request, stating that it would address the underwriters' points at the April 24, 2006 hearing. On April 24, 2006, the Court held a public hearing on the fairness of the proposed settlement. The Court took the matter under submission and has not yet ruled.

On February 12, 2004, we filed suit against Insight Enterprises, Inc., the acquirer of Comark, Inc., a value-added reseller of our software, claiming *inter alia* breach of contract and failure to pay in connection with a sale of our software to one customer in the Superior Court of the State of California, Santa Clara County. The lawsuit seeks in excess of \$600,000 in damages.

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

**Item 1A. Risk Factors**

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Since the filing of our Annual Report on Form 10-K for our fiscal year ended June 30, 2005, we have deleted certain risk factors relating to the effect of our cost reduction initiatives and restructurings on our employees. Although employee turnover and poor moral could reduce our efficiency and our ability to meet the needs of our customers, we do not believe that the effects of our restructurings continue to negatively impact our current employees' moral. The last of these restructuring occurred more than 2 years ago and we believe our current employees generally have less concerns about planned work force reductions relating to declines in our operating levels.

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

None.

**Item 3. Defaults upon Senior Securities**

None.

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

None

**Item 5. Other Information**

None.

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**Item 6. Exhibits**

Exhibits No.	Description of Exhibits
10.1	Amendment to Loan and Security Agreement between eGain and Silicon Valley Bank, dated January 27, 2006.
31.1	Rule 13a-15(e)/15d-15(e) Certification of Chief Executive Officer.
31.2	Rule 13a-15(e)/15d-15(e) Certification of Chief Financial Officer.
32.1	Certification pursuant to 18.U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002 of Ashutosh Roy, Chief Executive Officer.*
32.2	Certification pursuant to 18.U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002 of Eric Smit, Chief Financial Officer.*

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



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**SIGNATURES**

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

Dated: May 15, 2006

eGAIN COMMUNICATIONS CORPORATION

By

/s/ Eric N. Smit  
Eric N. Smit

Chief Financial Officer

(Duly Authorized Officer and

Principal Financial and Accounting Officer)

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