SUMTOTAL SYSTEMS INC

FORM 10-Q/A
(Amended Quarterly Report)

Filed 09/15/06 for the Period Ending 06/30/06

Address	1808 N. SHORLINE BLVD. MOUNTAIN VIEW, CA 94043
Telephone	6509349500
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q/A
Amendment No. 1

(Mark One)

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

For the quarterly period June 30, 2006

OR

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

For the transition period _______to ______

Commission File Number 000-50640

SUMTOTAL SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**42-1607228** **(I.R.S. Employer Identification No.)**

1808 North Shoreline Boulevard
Mountain View, California 94043
(Address of principal executive offices, including zip code)

(650) 934-9500
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 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 a non-accelerated file. See definition of "accelerated filer" in Rule 12b-2 of the Exchange Act.

☐ 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 ☒

The number of shares outstanding of the issuer's Common Stock, par value $0.001, including shares held in escrow, as of July 31, 2006 was approximately 25,552,690 shares.

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SUMTOTAL SYSTEMS, INC.

FORM 10–Q

For the Quarter Ended June 30, 2006

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Explanatory Note

The Company is hereby amending its Form 10-Q for the quarter ended June 30, 2006 to revise the disclosure regarding Controls and Procedures in Part I, Item 4 and a related risk factor in Part II, Item 1A.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

Management, including our Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of June 30, 2006. Our disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported accurately and on a timely basis, 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 disclosures.

Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were not effective as of June 30, 2006 because the three material weaknesses described below and in our Form 10-K for the period ended December 31, 2005 were not fully remediated as of June 30, 2006.

To address the three material weaknesses described below, we performed additional analyses and other post-closing substantive management review procedures to ensure our consolidated financial statements were prepared in accordance with generally accepted accounting principles. These included detailed reviews by the Corporate Controller and/or the Chief Financial Officer of (i) all significant revenue transactions, (ii) aged receivables to determine collectibility, (iii) invoices received after the end of the period to ensure that accruals were appropriate, and (iv) analyses and/or reconciliations of all material balance sheet and statement of operations accounts. Accordingly, management, including our Chief Executive Officer and Chief Financial Officer, believe the condensed consolidated financial statements included in this report fairly present, in all material respects, our financial condition, results of operations and cash flows for the periods presented.

(b) Management’s Report on Internal Control Over Financial Reporting

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2005. Management’s assessment identified the following material weaknesses in the Company’s internal control over financial reporting as of December 31, 2005:

1. *Inadequate reviews of account reconciliations, analyses and journal entries as well as spreadsheet controls.* We had inadequate review procedures over account reconciliations, account and transaction analyses, journal entries as well as certain spreadsheets.

These were originally discovered by management during its documentation, testing and evaluation of internal controls over financial reporting as of December 31, 2004. This initial review occurred during the period May 2004 through July 2005. Management further determined that the material weakness still existed as of December 31, 2005 during its documentation, testing and evaluation of internal controls over financial reporting that occurred during the period from August 2005 through March 2006.

Individually the control deficiencies did not rise to the level of a material control weakness but in aggregate these deficiencies resulted in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Specifically, control deficiencies were noted in the following areas:

- Review of journal entries, supporting documentation, calculations and assumptions used to prepare the financial statements and account analyses. The summary sheet of the work papers supporting our annual goodwill and intangible asset impairment analysis contained an error that was not noted during the review and approval process. Additionally, the final bad debt reserve analysis was not updated to reflect changes made to the related final accounts receivable reconciliation.
- Security protection, input data accuracy and logic review over certain spreadsheets used in period-end accounting, analysis and reporting. There was a lack of password protection, version control, and review of the underlying formulas and data logic review for the spreadsheets related to our restructuring reserve analysis, pro-forma stock based compensation analysis, and certain vendor specific objective evidence analyses.

- Review of stock option information and assumptions input into third party software and reconciliations to ensure data integrity. There was no evidence of documented review for one stock option grant made during the year. Additionally, there was inadequate evidence of review of the interest rate, volatility and options life assumptions input into our third party software system.
- Review of period-end accruals and reconciliations in the procurement cycle. There were unexplained reconciling differences in one of the underlying account reconciliations. Additionally, there was inadequate documentation of the review and approval of miscellaneous expense reimbursements.

2. *Inadequate controls over revenue* .

These were originally discovered by management during its documentation, testing and evaluation of internal controls over financial reporting as of December 31, 2004. This initial review occurred during the period May 2004 through July 2005. Management further determined that the material weakness still existed as of December 31, 2005 during its documentation, testing and evaluation of internal controls over financial reporting that occurred during the period from August 2005 through March 2006.

Certain key controls and review procedures over accounting for revenue were not functioning effectively. Specifically,

- Documentation of certain revenue recognition decisions was lacking. Formal evidence of timely review and approval of certain revenue recognition decisions was inconsistent and inadequate.
- Review procedures over the application of revenue recognition policies for software license and service arrangements were inadequate. There were errors in our documentation of the application of revenue recognition policies to certain software and service arrangements. Additionally, there were errors in the reconciliations of certain deferred revenue accounts which were not noted during the review and approval process.
- Review procedures over the accounting for service projects, such as the review of documentation supporting project milestone delivery or professional service hours rendered were inadequate. There was insufficient evidence of project set-up review and approval for certain service arrangements. Additionally, there was inadequate review and approval of third party time and expense for a certain service arrangement.
- Review procedures relating to royalty customer listings, fixed price contracts and the application of cash receipts were inadequate. There was inadequate evidence of timely review and approval of the set-up of certain customer royalty and fixed price arrangements. Additionally, there was inadequate evidence of timely review and approval of our posting of cash receipts.
- Review procedures relating to shipping documentation for the accuracy of revenue cut-off were inadequate. There was inadequate evidence of timely review and approval and shipping documentation related to certain revenue transactions that occurred during the cut-off period in the third quarter of 2005. Although this was corrected as of December 31, 2005 there was inadequate data available for testing to conclude that the deficiency had been corrected as of year-end.

3. *Inadequate controls over integration of business acquired* .

We had inadequate review procedures and controls surrounding the fourth quarter acquisition and integration of Pathlore. These were discovered by the Company’s independent registered public accounting firm during its audit of the financial statements and internal control over financial reporting for the fiscal year ended December 31, 2005.

- Certain differences in accounting policies were not initially correctly and completely harmonized prior to year-end, resulting in adjustments as of December 31, 2005. These differences were conforming the calculation of the bad debt reserve at Pathlore to the same methodology as SumTotal, adjusting the calculation of maintenance and hosting revenue recognized to a daily proration for partial months and correctly netting down billed amounts which were not contractually committed reducing receivables and deferred revenue by the same amount
- Certain of the acquisition-related adjusting journal entries were not reviewed by the appropriate level of management. The work papers calculating the allocation of purchase price to underlying assets were reviewed and approved. However, the journal entries reflecting this work were not approved.

These deficiencies resulted in more than a remote likelihood that a material misstatement of our annual or interim financial statements would not be prevented or detected.

In making our assessment, management used the criteria set forth by COSO in *Internal Control—Integrated Framework* . Because of the material weaknesses described above, management concluded that, as of December 31, 2005, our internal control over financial reporting was not effective based on those criteria.

(c) Changes in Internal Control Over Financial Reporting

During 2005 and the first half of 2006 we designed and implemented numerous initiatives to improve the internal control structure of the Company. The parties responsible for designing and implementing the initiatives referenced below are the Chief Executive Officer, Chief Financial Officer, Corporate Controller, and Audit Committee of our Board of Directors. Commencing in March 2005, we began the process of designing and creating the initiatives described below to remediate the material weaknesses identified in our Form 10-K for the years ended December 31, 2004 and 2005. The Chief Financial Officer was responsible for assigning actions to appropriate personnel within the accounting and information technology functions.

The following initiatives were created and implemented in fiscal year 2005 to address the material control weaknesses identified as of December 31, 2004 and to generally improve the Company's internal controls over financial reporting.

With respect to Company level controls, the Company fully remediated, by December 31, 2005, the material control weakness identified in our Form 10-K for the year ended December 31, 2004 by creating and implementing the following initiatives:

- strengthened its internal controls over financial reporting throughout its management structure. This included adding additional members to its Disclosure Committee, increasing the time spent by the executive staff in reviewing and discussing the Company's periodic filings and convening more frequent Audit Committee meetings. These changes were initiated to provide for a more robust review and analysis of the Company's periodic filings;
- hired additional finance and accounting personnel with expertise in U.S. generally accepted accounting principles, including two senior financial positions – one in Europe and one in the U.S., upgrading and adding staff to the accounting function at the manager and accountant level and engaging three experienced consultants to provide additional technical expertise as needed;
- strengthened its risk assessment controls, including mechanisms for anticipating and identifying financial reporting risks and for reacting to changes in the operating environment that could have a material effect on financial reporting . A large part of the additional time spent by executive management and the Audit Committee was focused on risk assessment and, in particular, in reviewing the risk factors disclosed in the Company's periodic filings;
- communicated the importance of internal controls and employee duties and responsibilities. The Company held internal training sessions with employees and discussed internal controls at Company-wide employee meetings; and
- implemented procedures surrounding its access controls and segregation of duties between key IT functions. This included segregating the roles of system administrators and users, restricting access to individual modules within the accounting function, segregating duties between network and application administrators, restricting access, implementing peer reviews, and requiring additional approvals for changes to applications and related databases.

With respect to segregation of duties, the Company fully remediated, by December 31, 2005, the material control weakness identified in our Form 10-K for the year ended December 31, 2004 by creating and implementing procedures and controls surrounding segregation of duties within its purchasing, disbursement and payroll processes and accounting system. This included the development of a segregation of duties matrix, reassignment of certain duties where the analysis indicated that there was not adequate segregation of duties, and restriction of access to certain accounting modules. In addition, the Company performed an analysis of customer and vendor accounts to ensure their existence and validity.

With respect to financial statement preparation and review procedures, the Company believes that it has remediated, by December 31, 2005, the material control weakness identified in our Form 10-K for the year ended December 31, 2004 by creating and implementing strengthened procedures surrounding the level of supporting documentation, review and supervision within the accounting and finance departments, and preparation and review of footnote disclosures. All reviews are fully documented and dated, and believed to be effective. However, deficiencies related to our reviews of account reconciliations, analyses and journal entries as well as spreadsheet controls remained as of December 31, 2005. Individually, the control deficiencies did not rise to the level of a material control weakness but in aggregate, these deficiencies resulted in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

With respect to purchases, payroll and disbursements, the Company fully remediated, by December 31, 2005, the material control weakness identified in our Form 10-K for the year ended December 31, 2004 by creating and implementing the following initiatives:

- strengthened controls and approvals surrounding wire transfers and transfers between investment accounts and the payment of invoices. This included adding a requirement for a second approver on all wire transfers and more rigorous enforcement of the authority levels for approving invoices;
- enhanced policies surrounding purchase orders. In particular, the Company enforced the Company policy that requires initiation of a purchase order before vendors are engaged to provide goods and services and further clarified which types of expenses could be paid without a purchase order;
- improved the review process of employee expense reports to ensure that exceptions to the policy were appropriately reviewed and approved; and
- improved the procedures surrounding the review and approval of commission payments to provide a more detailed review of the calculations as well as to ensure the reviews of commission payments were properly documented.

With respect to accounting for investments, the Company fully remediated, by December 31, 2005, the material control weakness identified in our Form 10-K for the year ended December 31, 2004 by creating and implementing strengthened policies and procedures regarding the review of investments managed by a third party. In particular, the Company ensured that there was a review of compliance with the Company's investment policy and a review to ensure the correct classification of the investments on the balance sheet.

During the quarter ended March 31, 2006, the Company:

- Appointed a Worldwide Director of Revenue to oversee the revenue recognition process, procedures and review of these transactions. The Worldwide Director was appointed by the Company's CFO and reports to the Company's Corporate Controller.
- Continued to hire additional qualified personnel to strengthen the accounting and finance organizations. We hired a payroll accountant and a general accountant, both of whom report to and are supervised by the Company's accounting manager. We also hired a revenue recognition supervisor reporting directly to our Worldwide Director, and a manager of credit and collections reporting to our Corporate Controller.
- Improved training for staff to ensure that account reconciliations and analyses are complete and accurate. We conducted accounting department training regarding the required format and content of the documentation for our account reconciliations and supporting analysis. This training was reviewed and approved by our CFO and conducted by our Corporate Controller.

During the quarter ended June 30, 2006, the Company:

- Continued to hire additional qualified personnel to strengthen the accounting and finance organizations. We hired an accounts payable accountant and an accounting supervisor, both of whom report to and are supervised by our accounting manager. We also hired an additional credit and collections specialist, who reports to our manager of credit and collections, and additional staff in the revenue accounting team.
- Continued to improve training for staff to ensure that roles and responsibilities are clearly defined and understood and that policies and procedures are being followed. This training was provided to all accounting and finance personnel and was performed by our Corporate Controller with the assistance of the internal audit function. This training was reviewed and approved by the Chief Financial Officer.
- Completed the integration of Pathlore. All transactions are now processed through the same systems and controls as other parts of the business This integration was supervised and monitored by the Corporate Controller.
- Initiated an upgrade and enhancement of our automated accounting and reporting systems that included improved internal controls, in particular with respect to segregation of duties. This upgrade was reviewed and approved by our IT Steering Committee and under the direction of our Director of Finance.
- Established an internal audit function reporting directly to the Audit Committee.
- Reviewed and enhanced our accounting and reporting policies and procedures. This was performed under the review and direction of our Chief Financial Officer and supervised by our Corporate Controller.

- Enhanced our ongoing formal internal control monitoring and testing program. This was performed via the establishment of an internal audit function under the direction and approval of the Company's Audit Committee. The Director of Internal Audit meets approximately twice each month with the Chief Executive Officer and Chief Financial Officer to discuss and report on the status of the Company's internal controls and meets approximately once per quarter with the Audit Committee.

These initiatives are part of our overall program that is intended to remediate all material control weaknesses by December 31, 2006. Management believes that it has developed and implemented the requisite initiatives to fully remediate all previously identified material control weaknesses, but the material control weaknesses identified in our Form 10-K for fiscal year 2005 related to (a) inadequate reviews of account reconciliations, analyses and journal entries as well as spreadsheet controls; (b) inadequate controls over revenue; and (c) inadequate controls over integration, remain subject to testing. Management has and will continue to test and evaluate these controls throughout the remainder of the year in order to enable management to make a conclusion, as of December 31, 2006, as to whether the initiatives were effective in fully remediating these remaining material control weaknesses.

PART II—OTHER INFORMATION

Item 1A. Risk Factors

Factors That May Affect Future Results of Operations

Set forth below and elsewhere in this and in other documents we file with the SEC are risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward-looking statements contained in this report. All forward-looking statements included in this report are based on information available to us on the date hereof. We assume no obligation to update any forward-looking statement.

We have a history of losses, we expect future losses on a Generally Accepted Accounting Principles ("GAAP") basis, and we may not achieve GAAP profitability on a consistent basis.

We expect to continue to derive substantially all of our revenue from the licensing of our new business performance and learning technology software family of products, the SumTotal 7.x Series, as well as our legacy products, Aspen Learning Management Server and Aspen Learning Content Management Server, Docent Learning Management Server and Docent Learning Content Management System, and Pathlore products ("Legacy Products") and related services, including without limitation, maintenance, services and hosting. We do not expect revenues from these product offerings to be sufficient to achieve and maintain U.S. GAAP profitability on a consistent basis. With the exception of the Pathlore mainframe products which we acquired in the fall of 2005, we began to transition our Legacy Products to our SumTotal 7.x Series and services related to these offerings at the end of the fourth quarter of 2004 and beginning the first quarter of 2005. If we fail to continue to generate adequate revenues from the SumTotal Systems Suite and related services, we will continue to incur losses. In addition, in the future, we expect to continue to incur additional non-cash expenses relating to the amortization of deferred compensation and purchased intangible assets that will contribute to our net losses. Further, starting with the first quarter of fiscal 2006, we have been required to record as an expense charges related to all current outstanding and future grants of stock options in our reported results from operations in accordance with Statement of Financial Accounting Standards ("SFAS") No. 123(R), *Share-Based Payments* , which was issued by the FASB in December 2004. This has had the impact of increasing our reported expenses and our U.S. GAAP losses. As a result of all of the foregoing, we expect to incur additional U.S. GAAP basis expenses related to stock-based compensation awards for the foreseeable future and these future expenses will adversely impact our ability to achieve profitability on a U.S. GAAP basis. Continued losses or failure to meet or exceed our forecasts or industry analysts' projections could cause the price of our common stock to decline.

Our operating results are uncertain and may fluctuate significantly from quarter to quarter or year to year, which could negatively affect the value of your investment.

We have experienced substantial fluctuations in operating results on a quarterly and annual basis and expect these fluctuations will continue in the future. Our operating results may be affected by a number of other factors, including: (1) the size and timing of product orders and the timing and execution of professional services engagements for SumTotal 7.x Series and the Legacy Products; (2) the mix of revenue from products and services; (3) the ability to meet client project milestones; (4) market acceptance of our products and services, especially SumTotal 7.x Series and related services; (5) failure to complete fixed-price professional services engagements within budget, on time and to clients' satisfaction; (6) ongoing costs and efforts in connection with compliance with Section 404 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Section 404"); (7) the timing of revenue and expense recognition; (8) the overall movement toward industry consolidation among both our competitors and our customers; (9) recognition of impairment of existing assets; and (10) how well we execute on our strategy and operating plans.

Our future revenue is difficult to predict, and we may not be able to adjust spending in response to revenue shortfalls. Our limited operating history with our current business performance and learning management solutions, and the rapidly evolving nature of the business performance and learning management market make prediction of future revenue and expenses difficult. Expense levels are based, in part, on expectations as to future revenue and are basically fixed in the short-term. Other expenses, as a result of changes in the law or otherwise, such as expenses related to litigation or compliance with Sarbanes-Oxley Section 404, may also increase and cause us to fall short of our forecasts. If we are unable to predict future revenue accurately, including, in particular, the timing of future revenue, we may be unable to adjust spending in a timely manner to compensate for any unexpected revenue shortfall, and may therefore fall short of our forecasts. Failure to meet our forecasts or industry analysts' expectations would likely cause a decline in the price of our common stock.

Risk of Impairment of Goodwill and Intangible Assets

Goodwill represents the excess of costs over the net fair value of net assets acquired in a business combination. Goodwill is not amortized, but is instead tested for impairment at least annually in accordance with the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets* . Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values using straight-line and accelerated methods designed to match the amortization to the benefits received where applicable. They are reviewed for impairment in accordance with SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets* . Recoverability of goodwill is measured by a comparison of the carrying amount of a reporting unit, which is a component representing a segment or one level below a segment, to the estimated undiscounted future cash flows expected to be generated by the reporting unit. If the carrying amount of a reporting unit, after any adjustments required for other long-lived assets, exceeds its estimated future cash flows, an impairment charge is recognized in the amount by which the carrying amount of the unit exceeds its fair value.

Purchased intangible assets subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset group to the estimated undiscounted future cash flows expected to be generated by the asset group. If the carrying amount of an asset group exceeds its estimated future cash flows, an impairment charge is recognized in the amount by which the carrying amount of the asset group exceeds the fair value of the asset group.

Any significant adverse changes to the key assumptions about acquired businesses and their prospects or an adverse change in market conditions could result in a change to the estimation of fair value that could result in an impairment charge. Given the significance of the intangible asset balances as a percent of our total asset balance, an adverse change to the estimated fair value of intangible assets could result in an impairment charge that would be material to our reported results from operation and related financial statements.

Sales cycles are lengthy, requiring considerable additional investment with no assurance of generating revenue from our efforts.

The period between our initial contact with a potential customer and a customer's purchase of our products and services often extends over several fiscal quarters or a fiscal year. To sell our products and services successfully, we generally must educate our potential customers regarding the use and benefits of our products and services, which typically requires significant time, capital and other resources. The delay or failure to complete sales in a particular quarter could reduce our revenue in that quarter, as well as subsequent quarters over which revenue for the sale would likely be recognized. If the sales cycle unexpectedly lengthens in general or for one or more large orders, it would negatively affect the timing of our revenue, and our revenue growth would be harmed. Many of our potential customers are large enterprises that generally take longer than smaller organizations to make significant business decisions, and the formation and execution of even a relatively small number of large contracts with these enterprise customers may have a significant impact on our revenues. In addition, we must allocate and expend resources prior to completing a sales transaction, with no guarantee that a particular sales transaction will be consummated, resulting in a failure to generate any revenue from these activities if the particular sales transaction is not consummated and potentially affecting our stock price as well.

Our operating results may be affected by successful warranty claims, refund requests, litigation claims for breach of contract or other claims related to product defects.

Although we generally attempt to contractually limit our liability for damages arising from defects and other mistakes in rendering professional services, these contractual protections are not always obtained and may not be enforced or otherwise may not protect us from liability for claims such as warranty claims, refund claims, or litigation claims. If such a claim is successful, our insurance may not be sufficient to cover these claims. Any of these consequences could have a material adverse impact on our financial condition, results of operations, our reputation, or the market value of our common stock.

Any future acquisitions we make, or attempt to make, could disrupt our business and harm our financial condition if we are not able to close an announced transaction or successfully integrate the acquired business in a timely manner.

We have made and may continue to make acquisitions of business and technologies to enhance our business. Acquisitions involve numerous risks, including problems combining the purchased operations and key employees, technologies or products, unanticipated costs, diversion of management's attention from our core business, adverse effects on existing business relationships with suppliers and customers, risks associated with entering markets in which we have no or limited prior experience and potential loss of key employees. The integration of businesses that we have acquired or that we may acquire in the future into our business has been and will continue to be a complex, time consuming and expensive process. Failure to operate as a combined organization utilizing common information and communication systems, operating procedures, financial controls and human resources practices could adversely impact the success of any business combination as evidenced in previous combination and acquisition transactions. For example, although we completed the combination of Docent and Click2learn in March 2004, the difficulty in integrating financial controls and procedures contributed to our failure to timely file our Annual Report on Form 10-K with the SEC for fiscal 2004. We are in the process of integrating Pathlore's financial controls into ours, and we may experience problems with this integration. Moreover, the integration of the products, product roadmap, and operations from the combination of Docent, Click2learn and Pathlore is a continuing activity and will be for the foreseeable future.

Our operating results may suffer because of acquisition-related expenses, amortization of intangible assets and impairment of acquired goodwill or intangible assets. Furthermore, we may have to incur debt or issue equity securities to pay for any future acquisitions, or to provide for additional working capital requirements, the issuance of which could be dilutive to our existing shareholders. If we are unable to successfully address any of these risks, our business, financial condition or operating results could be harmed.

There can be no assurance that we will be able to timely close other acquisitions, or other business combinations we may make in the future on favorable terms or on a timely basis, or that we will be able to successfully integrate Pathlore or any other businesses, products, technologies or personnel that we might acquire and failure to do so may negatively affect our financial results, customer, employee and investor confidence, and ultimately our stock price.

Our credit facility requires compliance with certain restrictive covenants, and if we breach the covenants, we will be in default and the lender could demand repayment and foreclose on the loan.

The credit facility we established in conjunction with our acquisition of Pathlore requires compliance with certain restrictive covenants. If we cannot achieve the financial results necessary to maintain compliance with these covenants, we could be declared in default and be required to sell or liquidate our assets to repay outstanding debt of approximately $15.3 million. These covenants include, but are not limited to, earnings before interest, taxes, depreciation and amortization ("EBITDA") levels, leverage ratios, and restrictions related to capital expenditures, indebtedness, distributions, investments, and change of control. There is no test of the financial covenants if the company maintains a minimum balance of at least $15.0 million between qualified cash accounts (accounts pledged to the lender) and excess availability under the revolver. As of June 30, 2006, we had $21.6 million comprising $16.6 million in qualified cash accounts and $5.0 million in excess availability under the revolver and therefore no test of the covenants was required. In the event that our qualified cash balance falls below the $15.0 million threshold and it cannot achieve the financial results necessary to maintain compliance with these covenants, we could be declared in default and be required to sell or liquidate its assets to repay outstanding debt of approximately $15.3 million.

If we breach any of these covenants, the lender could demand repayment of the outstanding debt and could foreclose upon all or substantially all of our assets and the assets of our subsidiaries. These covenants may adversely affect our ability to finance future operations, potential acquisitions or capital needs or to engage in other business activities that may be in our interest. As a result of our credit facility, we may have more debt than some of our competitors, which could place us at a competitive disadvantage and make us more susceptible to downturns in our business in the event our income is not sufficient to cover our debt service requirements. Even if we are able to repay the debt, under the terms of the credit facility, there are penalties for making pre-payments that would otherwise save us substantial future interest payments. The forced premature repayment of the loan could leave us without: (1) the ability to control which assets are sold to satisfy the loan; and (2) sufficient assets to continue as a going concern. Each of these risks may cause concern among our customers or investors and therefore cause a decrease in our revenues or stock price.