SUMTOTAL SYSTEMS INC

FORM 10-Q
(Quarterly Report)

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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 September 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	**42-1607228**
(State or other jurisdiction of incorporation or organization)	**(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 October 31, 2006 was approximately 25,805,523 shares.

Table of Contents

SUMTOTAL SYSTEMS, INC.

FORM 10–Q

For the Quarter Ended September 30, 2006

TABLE OF CONTENTS

		Page
PART I – FINANCIAL INFORMATION		
Item 1.	Consolidated Financial Statements (unaudited)	
	Condensed Consolidated Balance Sheets as of September 30, 2006 and December 31, 2005	4
	Condensed Consolidated Statements of Operations for the three and nine-months ended September 30, 2006 and 2005	5
	Condensed Consolidated Statements of Cash Flows for the nine-months ended September 30, 2006 and 2005	6
	Notes to the Condensed Consolidated Financial Statements	7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	27
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	39
Item 4.	Controls and Procedures	39
PART II – OTHER INFORMATION		
Item 1.	Legal Proceedings	44
Item 1A.	Risk Factors	44
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds.	55
Item 3.	Defaults upon Senior Securities	55
Item 4.	Submission of Matters to a Vote of Securities Holders	55
Item 5.	Other Information	55
Item 6.	Exhibits	55
SIGNATURES		57

Forward-Looking Statements

This Quarterly Report, including "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 2, includes "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. This Act provides a "safe harbor" for forward-looking statements to encourage companies to provide prospective information so long as they identify these statements as forward-looking and provide meaningful cautionary statements identifying important factors that could cause actual results to differ from the projected results. All statements other than statements of historical fact we make in this Quarterly Report are forward-looking. Such forward-looking statements including the words "may", "plans", "expects", "anticipates", "intends", "targets", "goals", "seeks", "believes", "potential", "continue" and similar language, including variations of such words and include, but are not limited to, statements regarding the following: our belief that our available cash resources, combined with cash flows generated from revenues, will be sufficient to meet our presently anticipated working capital and capital expense and business expansion requirements for at least the next 12 months; our belief that current litigation and other legal proceedings will not have a material adverse effect on our business, operating results and financial condition; statements about future business operations, including future product launches; marketing statements; industry leadership; internal controls and procedures; statements about our new product, SumTotal 7.x Series; revenue recognition; continued growth in our revenues from our professional service organization; the ability of our hedging program to reduce fluctuations caused by changes in exchange rates; financial performance including, but not limited to, estimated revenues, bookings, operating expenses, gross margins, interest income and expense, profit, and market conditions that include risks and uncertainties are based on information that is available to us at the date of this Quarterly Report on Form 10-Q and reflects management's then current expectations, estimates, beliefs, assumptions and goals and objectives, and are subject to uncertainties that are difficult, if not impossible, to predict. Our actual results may differ significantly from those projected in the forward-looking statements.

Factors that might cause or contribute to such differences include, but are not limited to those discussed in the section "Management's Discussion and Analysis of Financial Condition and Results of Operations — Factors That May Affect Future Results of Operations." You are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document.

Table of Contents

PART I – FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

SUMTOTAL SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	September 30, 2006 (Unaudited)	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 13,449	$ 18,356
Restricted cash	23	133
Short-term investments	4,175	657
Accounts receivable, net of allowance for sales returns and doubtful accounts of $893 and $1,407, respectively	23,201	25,207
Prepaid expenses and other current assets	3,431	3,484
Total current assets	44,279	47,837
Property and equipment, net	5,355	4,210
Goodwill	62,306	62,306
Intangible assets, net	19,119	25,705
Other assets	1,095	1,489
Total assets	$ 132,154	$ 141,547
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 3,720	$ 2,845
Accrued compensation and benefits	6,534	5,509
Other accrued liabilities	4,303	4,048
Restructuring accrual	997	1,831
Deferred revenue	24,931	26,354
Liability for litigation settlement	1,039	970
Notes payable	4,375	4,877
Total current liabilities	45,899	46,434
Non-current liabilities:		
Other accrued liabilities, non-current	235	176
Restructuring accrual, non-current	30	808
Deferred revenue, non-current	461	369
Liability for litigation settlement, non-current	1,634	2,333
Notes payable, non-current	9,844	13,125
Total liabilities	58,103	63,245
Commitments and contingencies (Notes 6 and 7)		
Stockholders' equity:		
Common stock	26	25
Additional paid-in capital	346,884	342,041
Deferred stock-based compensation	—	(804)
Accumulated other comprehensive income (loss)	(124)	356
Accumulated deficit	(272,735)	(263,316)
Total stockholders' equity	74,051	78,302
Total liabilities and stockholders' equity	$ 132,154	$ 141,547

Refer to the accompanying Notes to the Condensed Consolidated Financial Statements.

SUMTOTAL SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited, in thousands, except per share data)

	Three-Months Ended September 30,		Nine-Months Ended September 30,	
	2006	2005	2006	2005
Revenue:				
License	$ 7,169	$ 6,629	$22,014	$17,286
Service and maintenance	19,785	11,780	54,346	33,750
Total revenue	26,954	18,409	76,360	51,036
Cost of revenue:				
License	289	212	632	1,072
Service and maintenance	9,849	5,368	27,260	15,368
Amortization of intangible assets	2,090	742	6,586	2,841
Total cost of revenue	12,228	6,322	34,478	19,281
Gross margin	14,726	12,087	41,882	31,755
Operating expenses:				
Research and development	4,572	3,068	12,711	8,897
Sales and marketing	7,895	5,673	22,760	17,800
General and administrative	4,571	3,288	15,123	10,929
Restructuring charge	68	—	68	—
Total operating expenses	17,106	12,029	50,662	37,626
Income (loss) from operations	(2,380)	58	(8,780)	(5,871)
Interest expense	(429)	(4)	(1,295)	(5)
Interest income	180	227	532	582
Other income (expense), net	(49)	(121)	131	(493)
Income (loss) before provision for income taxes	(2,678)	160	(9,412)	(5,787)
Provision for income taxes	12	29	7	60
Net income (loss)	$ (2,690)	$ 131	$ (9,419)	$ (5,847)
Net income (loss) per share, basic	$ (0.11)	$ 0.01	$ (0.38)	$ (0.28)
Net income (loss) per share, diluted	$ (0.11)	$ 0.01	$ (0.38)	$ (0.28)
Weighted average common shares outstanding, basic	25,131	21,207	24,914	20,973
Weighted average common shares outstanding, diluted	25,131	21,550	24,914	20,973

Refer to the accompanying notes to the Condensed Consolidated Financial Statements

Table of Contents

SUMTOTAL SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited, in thousands)

	Nine-Months Ended September 30,	
	2006	2005
Cash flows from operating activities:		
Net loss	$ (9,419)	$ (5,847)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	2,159	1,320
Amortization of acquired intangible assets	6,586	2,841
Accretion of interest on short-term investments	(30)	(121)
Loss on disposal of property and equipment	—	49
Provision for (recovery of) sales returns and doubtful accounts	(175)	197
Stock-based compensation	3,128	712
Changes in operating assets and liabilities:		
Accounts receivable, net	2,571	4,462
Prepaid expenses and other assets	80	(485)
Other assets	404	7
Accounts payable	845	(1,173)
Accrued compensation and benefits	980	(1,703)
Other accrued liabilities	238	185
Restructuring accrual	(1,612)	(402)
Liability for litigation settlement	(449)	—
Deferred revenue	(1,684)	888
Net cash provided by operating activities	3,622	930
Cash flows from investing activities:		
Purchases of property and equipment	(3,276)	(2,322)
Proceeds on disposal of property and equipment	—	19
Release of restricted cash	110	—
Costs associated with acquisition	—	(1,723)
Purchases of short-term investments	(4,502)	(6,877)
Maturities of short-term investments	1,014	12,516
Net cash provided by (used in) investing activities	(6,654)	1,613
Cash flows from financing activities:		
Payments on notes payable	(3,783)	—
Net proceeds from the issuance of common stock and exercises of common stock options	2,338	1,085
Net cash provided by (used in) financing activities	(1,445)	1,085
Effect of foreign exchange rate changes on cash	(430)	418
Net increase (decrease) in cash and cash equivalents	(4,907)	4,046
Cash and cash equivalents at beginning of period	18,356	25,508
Cash and cash equivalents at end of period	$13,449	$29,554
Supplemental disclosure of cash flow information		
Interest paid	$ 990	$ 5
Income taxes paid	$ 9	$ 52

Refer to the accompanying notes to the Condensed Consolidated Financial Statements.

SUMTOTAL SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1: DESCRIPTION OF BUSINESS

SumTotal Systems, Inc. ("SumTotal Systems" or the "Company") develops, markets, distributes and supports an integrated suite of enterprise learning software products. SumTotal Systems' markets are worldwide and include a broad range of industries. SumTotal Systems was formed on March 18, 2004, as a result of the acquisition of Docent, Inc. ("Docent") by Click2learn, Inc. ("Click2learn").

NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying financial data as of September 30, 2006, and for the three and nine-month periods ended September 30, 2006 and 2005 has been prepared by SumTotal Systems, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted pursuant to such rules and regulations. Certain other insignificant amounts have been reclassified to conform to the current period presentation. The December 31, 2005 Condensed Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by GAAP. However, SumTotal Systems believes that the disclosures are adequate to make the information presented not misleading.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments (which include normal recurring adjustments, except as disclosed herein) necessary to present fairly SumTotal Systems' financial position, results of operations and cash flows for the interim periods presented. The results of operations for the three and nine-month periods ended September 30, 2006 are not necessarily indicative of the operating results for the full fiscal year or any future periods. Factors that may affect such operating results, include, but are not limited to, those discussed in *"Factors That May Affect Future Results of Operations* ."

Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements include the financial statements of SumTotal Systems and its wholly owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenue and expenses during the reporting period. Such estimates and assumptions are based on historical experience, where applicable, and other assumptions. On an ongoing basis, SumTotal Systems evaluates estimates, including those related to revenue, allowance for sales returns and doubtful accounts, intangible assets, restructuring, stock-based compensation and valuation reserves for deferred tax assets. Actual results could differ from those estimates.

Revenue Recognition

SumTotal Systems recognizes revenue pursuant to the requirements of American Institute of Certified Public Accountants ("AICPA") Statement of Position ("SOP") No. 97-2, *Software Revenue Recognition* , as amended by SOP No. 98-9, *Software Revenue Recognition with Respect to Certain Arrangements* . Under SOP No. 97-2, revenue attributable to an element in a customer arrangement is recognized when persuasive evidence of an arrangement exists and delivery has occurred, provided the fee is fixed or determinable and collectibility is reasonably assured. SumTotal Systems' principal sources of revenue are from the sales of software licenses and products, services performed in connection with consulting agreements, maintenance and support services, and hosting arrangements. Allowances are provided for estimated returns, discounts and trade-ins. Such allowances are adjusted periodically to reflect actual and anticipated experience.

For all sales, SumTotal Systems typically uses either a binding purchase order or signed agreement, depending on the nature of the transaction, as evidence of an arrangement. Sales through its significant resellers are evidenced by a master agreement governing the relationship.

At the time of each transaction, SumTotal Systems assesses whether the fees associated with the transaction are fixed or determinable. If a significant portion of a fee is due after SumTotal Systems' normal payment terms, currently up to net ninety days (payment terms beyond ninety days are considered to be extended terms), or if the price is subject to forfeiture, concession, refund or adjustment, then SumTotal considers the fee to not be fixed or determinable. In these cases, revenue is deferred and recognized when payments become due and payable, or the right to refund or adjustment lapses.

SumTotal Systems assesses whether or not collection is reasonably assured based on a number of factors including the creditworthiness of the customer as determined by credit checks and analysis, past transaction history with the customer, the geographic location of the customer, and the financial viability of the customer. SumTotal Systems does not request nor does it require collateral from customers. If at the time of the transaction the determination is made, collection of the fee is not reasonably assured, then all of the related revenue is deferred until the time that collection becomes reasonably assured, which is deemed to have occurred when payment has been received.

SumTotal Systems uses shipping documents, proof of electronic transmittal, contractual terms and conditions, and customer acceptance, when applicable, to verify delivery to the customer. For perpetual software license fees in arrangements that do not include significant customization or consulting services, delivery is deemed to occur when the product is shipped to the customer or made available over the internet via the delivery of a key for downloading. Services and consulting arrangements that are not essential to the functionality of the licensed product, if any, are recognized as revenue, if VSOE exists, as these services are provided. Delivery of time-based licenses, subscription license bundles, hosting agreements and support agreements is generally considered to occur on a straight-line basis over the life of the contract.

SumTotal Systems' customers have the option of purchasing perpetual licenses, time-based licenses, or subscription license bundles (typically one year) that include hosting and maintenance and support. For perpetual software license fees in arrangements that do not include customization or consulting services, delivery typically is deemed to occur and the related revenue recognized as license revenue when the product is shipped to customers. When perpetual license arrangements contain multiple elements and vendor specific objective evidence of fair value exists for all undelivered elements, SumTotal Systems accounts for the delivered elements in accordance with the "residual method" prescribed by SOP No. 98-9 and as described below. Fair value of hosting and maintenance and support services is based on separate sales and/or renewals to other customers or upon renewal rates quoted in contracts when the quoted renewal rates are deemed to be substantive. In the event that fair value for hosting and maintenance and support services does not exist, then revenue for the entire arrangement is recognized ratably over the performance period. Time based license sales are recognized ratably over the rental period and included as a component of license revenue. Subscription license bundles require the license holders to pay a monthly fee which is based on the number of users. SumTotal Systems recognizes revenue on subscription license bundles on a straight-line basis over the life of the subscription and records the revenue as service and maintenance revenue.

For multiple element arrangements, when Company-specific objective evidence of fair value exists for all of the undelivered elements of the arrangement, but does not exist for one of the delivered elements in the arrangement, SumTotal Systems recognizes revenue under the residual method. Under the residual method, at the outset of the arrangement with a customer, revenue is deferred for the fair value of its undelivered elements such as consulting services, product support and hosting. Revenue is recognized for the remainder of the arrangement fee attributable to the elements initially delivered, with the residual being allocated to delivered elements (typically software licenses), when all of the applicable criteria in SOP No. 97-2 have been met. Company-specific objective evidence is established for hosting and support and upgrades of standard products based upon the amounts SumTotal Systems charges when support, upgrades, and hosting are sold separately. Company-specific objective evidence is established for consulting and installation services based on the hourly rates SumTotal Systems charges for its employees when they are performing these services separately and provided SumTotal Systems has the ability to accurately estimate the hours required to complete the project based upon experience with similar projects.

Many of SumTotal Systems' software contracts include consulting implementation services. Consulting revenues from certain of these contracts are accounted for separately from the perpetual license revenues because the consulting arrangements qualify as "service transactions" as defined in SOP No. 97-2. The more significant factors considered in determining whether the revenue should be accounted for separately include the nature of services (i.e., consideration of whether the services are essential to the functionality of the licensed product), degree of risk, availability of the same services from other vendors, timing of payments and impact of milestones or acceptance criteria on the realizability of the software license fee. Revenues for consulting services are generally recognized as the services are performed. If there is a significant uncertainty about the project completion date or receipt of payment for the consulting services, revenue is deferred until the uncertainty is sufficiently resolved.

SumTotal Systems recognizes revenue on contracts with fixed or "not-to-exceed" fees and those with billing milestones to the extent that SumTotal Systems has a basis for measuring progress to completion and provided that all other

revenue recognition criteria have been met. If SumTotal Systems does not have a sufficient basis to measure progress towards completion, or if the service engagement is subject to final customer acceptance, then revenue is recognized when SumTotal Systems has completed all its obligations and/or received final acceptance from the customer. If SumTotal Systems has a sufficient basis to measure progress towards completion and the service engagement is either not subject to final customer acceptance or if acceptance is considered perfunctory based on experience with the customer and the work being performed, then revenue is recognized as the services are provided or by using input measures based on hours to complete, not to exceed milestone billings.

For arrangements that include customization or modification of the software, or where software services are otherwise considered essential, SumTotal Systems recognizes revenue using contract accounting. We generally use the percentage-of-completion method to recognize revenue from these arrangements. We measure progress-to-completion primarily using labor hours incurred or value added. The percentage-of-completion methodology generally results in the recognition of reasonably consistent profit margins over the life of a contract since we have the ability to produce reasonably dependable estimates of contract billings and contract costs. We use the level of profit margin that is most likely to occur on a contract. If the most likely profit margin cannot be precisely determined, the lowest probable level of profit in the range of estimates is used until the results can be estimated more precisely. These arrangements are often implemented over an extended time period and occasionally require us to revise total cost estimates. Amounts recognized in revenue are calculated using the progress-to-completion measurement after giving effect to any changes in our cost estimates. Changes to total estimated contract costs, if any, are recorded in the period they are determined. Estimated losses on uncompleted contracts are recorded in the period in which we first determine that a loss is apparent.

For arrangements that include new product releases for which it is difficult to estimate final profitability except to assume that no loss will ultimately be incurred, we recognize revenue under the completed contract method. Under the completed contract method, revenue and costs are recognized only when a contract is completed or substantially complete. Historically these amounts have been immaterial.

The cost of providing these services consists primarily of fully burdened cost of SumTotal Systems' service organization and to some extent, the cost SumTotal Systems pays to third party contractors who provide these services on SumTotal Systems' behalf. Costs for certain projects with significant uncertainties are expensed as they are incurred in accordance with SFAS No. 68, *Research and Development Arrangements* , and included in the cost of service revenue. The complexity of the estimation process and issues related to the assumptions, risks and uncertainties inherent with the application of the percentage of completion method of accounting affect the amounts of revenue and related expenses reported in our operating results. A number of internal and external factors can affect our estimates, including labor rates, utilization and efficiency variances and specification and testing requirement changes. Professional services from time and materials contracts and training services, along with the related costs are recognized as these services are performed.

Revenue from maintenance and support agreements is recognized on a straight-line basis over the life of the contract. Customers with perpetual or time-based licenses may also outsource to SumTotal Systems the hosting of their system on a third party's server for a monthly fee. Based on the criteria outlined in Emerging Issues Task Force ("EITF") No. 00-03, *Application of AICPA Statement of Position 97-2 to Arrangements that Include the Right to Use Software Stored on Another Entity's Hardware.* EITF No. 00-03 , SumTotal Systems has determined that its hosting arrangements are within the scope of SOP No. 97-2. The applicability of EITF No. 00-03 allows SumTotal Systems to recognize that portion of the fee attributable to the license on delivery, while that portion of the fee related to the hosting element is recognized ratably as the service is provided, assuming all other revenue recognition criteria of SOP No. 97-2 have been met. The costs of these services are recognized as incurred and included as a component in costs of services revenue.

Distributors and systems integrators purchase products for specific projects of the end-user and do not hold inventory. They perform functions that include importation, delivery to the end-customer, installation or integration, and post-sales service and support. The agreements with these distributors and systems integrators have terms which are generally consistent with the standard terms and conditions for the sale of our software to end users and do not provide for product rotation or pricing allowances, as are typically found in agreements with stocking distributors. SumTotal evaluates the terms of these sales and recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been provided, the sales price is fixed or determinable and collectibility is reasonably assured. Revenue on shipments to distributors, resellers and systems integrators is generally recognized on delivery or sell-in and after the end user has been identified.

Revenues from sales of third-party products net of royalties, are recorded in accordance with EITF No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent.* In accordance with EITF No. 99-19, SumTotal Systems evaluates sales through the indirect channel on a case-by-case basis to determine whether the transaction should be recorded gross or net, including but not limited to assessing whether or not SumTotal Systems: (1) acts as principal in the transaction;

(2) takes title to the products; (3) has risks and rewards of ownership, such as the risk of loss for collection, delivery, or returns, and; (4) acts as an agent or broker with compensation on a commission or fee basis. These sales are typically recorded gross.

Deferred revenue represents advanced payments for software licenses, services, maintenance and support, and hosting arrangements in advance of the time we recognize revenue. These deferred amounts are expected to be recognized ratably over the service period as these services are provided.

Net Income (Loss) Per Share

Basic and diluted net loss per share is computed by dividing the net loss for the period by the weighted average number of shares of common stock outstanding during the period, less outstanding unvested shares. The calculation of diluted net loss per share excludes potential common shares as the effect is anti-dilutive, due to SumTotal Systems' net loss in certain periods. There were also 391,665 shares held in escrow for the Pathlore Software Corporation ("Pathlore") acquisition that are also not included in the weighted average number of common shares outstanding during 2006 for both basic and diluted net loss per share. Potential common shares are comprised of common stock subject to repurchase rights, incremental shares of common and preferred stock issuable upon the exercise of stock options or warrants and shares issuable upon conversion of convertible preferred stock.

The following table sets forth the computation of basic and diluted net income (loss) per share for the three and nine-months ended September 30, 2006 and 2005 (in thousands, except per share amounts):

	Three-Months Ended September 30,		Nine-Months Ended September 30,	
	2006	2005	2006	2005
Net income (loss)	$ (2,690)	$ 131	$ (9,419)	$ (5,847)
Weighted average common shares used to compute basic net income (loss) per share	25,131	21,207	24,914	20,973
Weighted average common shares used to compute diluted net income (loss) per share	25,131	21,550	24,914	20,973
Net income (loss) per share, basic	$ (0.11)	$ 0.01	$ (0.38)	$ (0.28)
Net income (loss) per share, diluted	$ (0.11)	$ 0.01	$ (0.38)	$ (0.28)

The following table sets forth the common stock options and warrants that have been excluded from the computation of diluted loss per share because their effects would have been anti-dilutive for the three and nine-months ended September 30, 2006 and 2005 (in thousands, except weighted average prices):

	Three-Months Ended September 30,		Nine-Months Ended September 30,	
	2006	2005	2006	2005
Options to acquire shares of common stock	2,755	3,335	2,827	4,313
Weighted average option price	$ 10.15	$ 10.71	$ 10.04	$ 8.94
Warrants to acquire shares of common stock	1,577	1,642	1,577	1,642
Weighted average warrant price	$ 7.67	$ 8.50	$ 7.67	$ 8.50

Comprehensive Income (Loss) and Accumulated Other Comprehensive Income

The following table sets forth the components of comprehensive income (loss) for the three and nine-months ended September 30, 2006 and 2005 presented below (in thousands):

	Three-Months Ended September 30,		Nine-Months Ended September 30,	
	2006	2005	2006	2005
Net income (loss)	$ (2,690)	$ 131	$ (9,419)	$ (5,847)
Unrealized gain (loss) on investments	2	(8)	2	(15)
Foreign currency translation adjustment	(100)	82	(480)	418
Comprehensive income (loss)	$ (2,788)	$ 205	$ (9,897)	$ (5,444)

SumTotal Systems' total comprehensive income (loss) for the nine-months ended September 30, 2006 and 2005 consisted of net loss, unrealized gains (losses) on investments and the change in foreign currency translation adjustments. The tax effects on the foreign currency translation adjustments have not been significant. Accumulated other comprehensive income (loss) consists of foreign currency translation adjustments of ($128,000) and $354,000 at September 30, 2006 and December 31, 2005, respectively, and an unrealized gain on investments of $4,000 and $2.000 at September 30, 2006 and December 31, 2005, respectively.

Stock-Based Compensation

Equity Compensation and Stock Option Plans

SumTotal Systems has adopted stock option plans and assumed stock option plans from acquisitions (the "Plans") that provide for the issuance of stock options to officers, employees, consultants, and directors to acquire up to 7,452,000 shares of common stock. Also, at SumTotal Systems' annual meeting of shareholders held on June 9, 2006, shareholders approved an amendment to the SumTotal Systems 2004 Equity Incentive Plan (the "2004 Plan") which increased the number of shares reserved for issuance under the 2004 Plan by 1,500,000 shares. The Compensation Committee determines the terms and conditions of options granted under the Plans, including the exercise price. The exercise price for incentive stock options shall not be less than the fair market value of the common stock at the date of grant, and the options expire ten years from the date of grant. Option grants generally vest at 25% after the first year and ratably each month thereafter for the next three years. All canceled options revert back to the option pool, other than options assumed under the 2000 IntelliPrep Equity Incentive Plan.

The 2004 Plan provides for the grant of the following types of incentive awards that are referred to individually as an "Award":

- stock options;
- stock appreciation rights;
- stock awards, restricted stock and stock units; and
- performance units and performance shares.

Those who are eligible for Awards under the plan include employees, directors, consultants, independent contractors or other persons who provide services to SumTotal Systems and its affiliates.

Restricted Stock

On May 26, 2005, the Compensation Committee of the Board of Directors of SumTotal Systems, Inc. granted to four senior executives a total of 275,000 shares of restricted stock with purchase consideration of $0.001 per share, containing vesting provisions of 25% after one year, 25% after two years, and the remaining 50% after three years. Since the date of the grant, a total of 156,250 in unvested shares have been cancelled as a result of executives who left the employment of the Company prior to vesting. As of September 30, 2006, 43,750 shares have had restrictions released pursuant to the vesting provisions described above.

Employee Stock Purchase Plan ("ESPP")

SumTotal Systems assumed the Click2learn 1999 ESPP in connection with the acquisition of Docent. On each January 1st, the aggregate number of shares reserved for issuance under plan is increased automatically by the number of shares purchased under the plan in the preceding year, which has the effect of making a total of 450,000 available for purchase each year. Employees participate in the ESPP through after-tax payroll deductions, which may not be less than 1% or more than 10% of the employee's total pre-tax cash compensation. Purchase periods commence on February 1st and August 1st of each year and consist of a six-month period during which payroll deductions of the participants are accumulated and shares are purchased on the final trading day of the period.

For purchase periods prior to February 1, 2006 the purchase price of shares acquired in the period under the ESPP was 85% of the lesser of the fair market value of the shares on the first day of the offering period or the fair market value of the shares on the purchase date. The offering period was twenty four months ending on the purchase date.

On February 1, 2006, SumTotal Systems amended the plan for future offering periods to change the offering price to 90% of the lesser of the fair market value of the shares on the first day of an offering period or the fair market value of the shares on the purchase date and shortened the offering period from twenty four months to six months. The change was made in order to reduce the expense charged to future statements of operations as a result of the Company implementing SFAS No. 123(R), *Share-Based Payment* .

The ESPP will continue until the earlier to occur of: (1) termination of the ESPP by the SumTotal Systems Board of Directors; (2) the total number shares purchased under the plan reaches the maximum allowed by the plan; or (3) March 24, 2009.

Stock-based Compensation Expense

On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment* , which establishes standards for the accounting of transactions in which an entity exchanges its equity instruments for goods or services, primarily focusing on accounting for transactions where an entity obtains employee services in share-based payment transactions. SFAS No. 123(R) requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments, including stock options, based on the grant-date fair value of the award and to recognize it as compensation expense over the period the employee is required to provide service in exchange for the award, usually the vesting period. SFAS No. 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion ("APB") No. 25, *Accounting for Stock Issued to Employees* for periods beginning in fiscal 2006. In March 2005, the SEC issued Staff Accounting Bulletin ("SAB") No. 107 relating to SFAS No. 123(R). The Company has applied the provisions of SAB No. 107 in its adoption of SFAS 123(R).

The Company adopted SFAS No. 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company's fiscal year 2006. The Company's unaudited condensed consolidated financial statements as of and for the three and nine-months ended September 30, 2006 reflect the impact of SFAS No. 123(R). In accordance with the modified prospective transition method, the Company's unaudited condensed consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123(R).

SFAS No. 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's unaudited condensed consolidated statement of operations. Prior to the adoption of SFAS No. 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB No. 25 as allowed under SFAS No. 123, *Accounting for Stock-Based Compensation* . Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company's unaudited condensed consolidated statements of operations, other than as related to restricted stock units and option grants to employees and directors with exercise prices below the fair market value of the underlying stock at the date of grant. Stock-based compensation expense recognized in the Company's unaudited condensed consolidated statement of

operations for the first nine months of fiscal 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS No. 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). As stock-based compensation expense recognized in the unaudited condensed consolidated statement of operations for the first nine months of fiscal 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Our estimated forfeiture rate for the three and nine-months ended September 30, 2006, of approximately 11.85% was based on historical compound annual forfeiture experience. In the Company's pro forma information required under SFAS No. 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred.

SFAS No. 123(R) requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options to be classified as financing cash flows. Due to the Company's loss position, there were no such tax benefits during the three and nine- months ended September 30, 2006. Prior to the adoption of SFAS No. 123(R) those benefits would have been reported as operating cash flows had the Company received any tax benefits related to stock option exercises.

The fair value of stock-based awards to employees is calculated using the Black-Scholes option pricing model, even though this model was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which differ significantly from the Company's stock options. The Black-Scholes model also requires subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values. The expected term of options granted is derived from the use of the simplified method under SAB No. 107. The risk-free rate is based on the U.S. Treasury rates in effect which most closely corresponds to a period of grant. The expected volatility is based on the historical volatility of our stock price over a period at least as long as the expected term of the options. These factors could change in the future, which would affect the stock-based compensation expense in future periods.

Valuation and Expense Information under SFAS No. 123(R)

The weighted-average fair value of stock-based compensation to employees is based on the single option valuation approach. Forfeitures are estimated and it is assumed no dividends will be declared. The estimated fair value of stock-based compensation awards to employees is amortized using the straight-line method over the vesting period of the options, except for restricted stock, which is amortized on a multi-option accelerated method, consistent with the prior year. The weighted-average fair value calculations for options granted within the period are based on the following weighted average assumptions:

	Three-Months Ended September 30, 2006	Nine-Months Ended September 30, 2006
Risk-free interest rate	4.76%	4.94%
Expected volatility	98.55%	98.38%
Expected life (years)	6.25	6.25

Options that were granted in prior periods are based on assumptions prevailing at the date of grant.

The following table summarizes stock-based compensation expense related to employee stock options and restricted stock units under SFAS No. 123(R) for the three and nine-months ended September 30, 2006 which was allocated as follows (in thousands):

	Three-Months Ended September 30, 2006	Nine-Months Ended September 30, 2006
Cost of revenue	$ 272	$ 754
Research and development	138	382
Sales and marketing	288	783
General and administrative	420	1,209
Stock-based compensation expense included in operating expenses	846	2,374
Total stock-based compensation expense	$ 1,118	$ 3,128

Table of Contents

The table below reflects net loss and basic and diluted net loss per share for the three and nine-months ended September 30, 2006 compared with the pro forma information for the three months and nine months ended September 30, 2005 as follows (in thousands except per-share amounts):

	Three-Months Ended September 30,		Nine-Months Ended September 30,	
	2006	2005	2006	2005
Net income (loss), as reported in the prior period (1)	$ NA	$ 131	$ NA	$ (5,847)
Stock-based compensation expense related to employee stock options (2)	(1,118)	(663)	(3,128)	(12,123)
Net loss, including the effect of stock-based compensation expense (3)	$ (2,690)	$ (532)	$(9,419)	$(17,970)
Basic and diluted net income (loss) per share as reported for the prior period (1)	$ NA	$ 0.01	$ NA	$ (0.28)
Basic and diluted net loss per share, including the effect of stock-based compensation expense (3)	$ (0.11)	$ (0.03)	$ (0.38)	$ (0.86)

(1) Net loss and net loss per share prior to fiscal 2006 did not include stock-based compensation expense for employee stock options under SFAS No. 123 because the Company did not adopt the fair value recognition provisions of SFAS No. 123.

(2) Stock-based compensation expense prior to fiscal 2006 is calculated based on the pro forma application of SFAS No. 123 and is presented net of any related tax benefit.

(3) Net income and net income per share prior to fiscal 2006 represents pro forma information based on SFAS No. 123.

A summary of option and restricted stock activity under the Company's stock equity plans during the nine months ended September 30, 2006 is as follows:

	Number of Shares (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2005	6,905	$ 7.24	7.72	
Granted	1,144	6.11		
Exercised	(462)	3.63		
Cancelled	(671)	11.70		
Outstanding at September 30, 2006	6,916	$ 6.86	7.61	$ 11,630
Exercisable at September 30, 2006	4,370	$ 7.82	6.74	$ 5,927

A summary of the status of the Company's restricted stock units as of December 31, 2005 and changes during the nine months ended September 30, 2006 is as follows:

Non-vested restricted shares	Number of Shares (in thousands)	Weighted Average Grant – Date Fair Value
Non-vested at December 31, 2005	175	$ 4.30
Granted	—	—
Vested	(44)	4.30
Cancelled	(56)	4.30
Non-vested at September 30, 2006	75	$ 4.30

The following table summarizes significant ranges of outstanding and exercisable options as of September 30, 2006.

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number (in thousands)	Weighted Average Remaining Contractual Term (in years)	Weighted Average Exercise Price	Number (in thousands)	Weighted Average Exercise Price
$ 1.07 -$ 4.34	1,272	6.96	$ 3.37	933	$ 3.09
$ 4.39 -$ 4.65	1,296	8.82	4.50	343	4.50
$ 4.67 -$ 6.05	1,158	8.82	5.58	339	5.30
$ 6.18 -$ 7.60	732	8.34	6.83	297	7.07
$ 7.62 -$ 7.62	1,336	7.54	7.62	1,336	7.62
$ 7.72 -$83.42	1,122	5.33	13.98	1,122	13.98
$ 1.07 -$83.42	6,916	7.61	$ 6.86	4,370	$ 7.82

The total intrinsic value of options exercised during the three and nine-months ended September 30, 2006 was approximately $568,000 and $1,207,000, respectively. The total intrinsic value of shares issued under the employee stock purchase plan during the three and nine months ended September 30, 2006 was approximately $143,000 and $239,000, respectively. The fair value of options and restricted stock vested was approximately $2.8 million for the nine months ended September 30, 2006. As of September 30, 2006, total unrecognized compensation costs related to non-vested stock options was $9.0 million, which is expected to be recognized as expense over a weighted average period of approximately three years. The weighted average grant date fair value of options granted in the three and nine months ended September 30, 2006, was $5.25 and $4.97, respectively.

Pro Forma Information Under SFAS No. 123 for Periods Prior to Fiscal 2006

Prior to fiscal 2006, the weighted-average fair value of stock-based compensation to employees was based on the single option valuation approach. Forfeitures were recognized as they occurred and it was assumed no dividends would be declared. The estimated fair value of stock-based compensation awards to employees was amortized using the straight-line method over the vesting period of the options. The weighted-average fair value calculations were based on the following weighted-average assumptions:

	Three-Months Ended September 30, 2005	Nine-Months Ended September 30, 2005
Risk-free interest rate	4.01%	3.99%
Expected volatility	106%	106% - 108%
Expected life (years)	1 day-4 years	1 day-4.19 years

Pro forma results are as follows (in thousands, except per share amounts):

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income (loss), as reported	$ 131	$ (5,847)
Add: Employee stock-based compensation expense included in reported net income (loss)	329	712
Less: Total employee stock-based compensation expense determined under fair value based method for all awards	(992)	(12,835)
Pro forma net loss	$ (532)	$ (17,970)
Basic and diluted net income (loss) per share, as reported	$ 0.01	$ (0.28)
Basic and diluted net loss per share, pro forma	$ (0.03)	$ (0.86)
Weighted average common shares outstanding, basic and diluted	21,207	20,973

In the three-months ended September 30, 2005, stock-based compensation expense relating to common stock options and restricted stock was $329,000 which consisted of the following: stock-based compensation expense relating to common stock options issued to former Docent employees of $119,000; stock-based compensation expense relating to restricted stock options issued to certain executives of $74,000; and stock-based compensation expense relating to the extension of the cancellation date for certain common stock options held by terminated employees of $136,000.

In the nine-months ended September 30, 2005, SumTotal Systems recorded $712,000 in stock-based compensation expense relating to common stock options and restricted stock which consisted of the following: stock-based compensation expense relating to common stock options issued to former Docent employees of $472,000; stock-based compensation expense relating to restricted stock options issued to certain executives of $104,000; and stock-based compensation expense relating to the extension of the cancellation date for certain common stock options held by terminated employees of $136,000.

Adoption of Accounting Standards

In June 2005, the Financial Accounting Standards Board (“FASB”) ratified the EITF’s Issue No. 05-06, *Determining the Amortization Period for Leasehold Improvements* . EITF No. 05-06 provides that the amortization period used for leasehold improvements acquired in a business combination or purchased significantly after the inception of a lease be the shorter of: (1) the useful life of the assets; or (2) a term that includes required lease periods and renewals that are reasonably assured upon the acquisition or the purchase. The provisions of EITF No. 05-06 are effective on a prospective basis for leasehold improvements purchased or acquired beginning in our first quarter of fiscal 2006. There was no material impact on our unaudited condensed consolidated financial position, results of operations or cash flows as a result of the adoption of EITF No. 05-06.

In June 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* , a replacement of APB No. 20, *Accounting Changes* and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements* . SFAS No. 154 changes the requirements for the accounting for, and reporting of, a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition of a cumulative effect adjustment within net income of the period of the change. SFAS No. 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, it does not change the transition provisions of any existing accounting pronouncements. There was no material impact on our unaudited condensed consolidated financial position, results of operations or cash flows as a result of the adoption of SFAS No. 154.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Non-monetary Assets, an amendment of APB Opinion No. 29, Accounting for Non-monetary Transactions.* SFAS No. 153 addresses the measurement of exchanges of non-monetary assets and redefines the scope of transactions that should be measured based on the fair value of the assets exchanged. SFAS No. 153 is effective for non-monetary asset exchanges beginning in our first quarter of fiscal 2006. There was no material impact on our unaudited condensed consolidated financial position, results of operations or cash flows as a result of the adoption of SFAS No. 153.

Recent Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation ("FIN") No. 48, *Accounting for Uncertainty in Income Taxes* . The effective date is the beginning of fiscal years beginning after December 15, 2006. Among many items of consideration under FIN No. 48, if a company takes a position, such as a deduction or a credit, on an income tax return and there is a possibility the position may not ultimately be sustained, that position is said to be uncertain. Computation of the required cumulative effect adjustment by that date may take a considerable level of effort. Management is in the process of evaluating whether FIN No. 48 will have an impact on the Company's results of operations and financial condition.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Instruments* , which permits, but does not require, fair value accounting for any hybrid financial instrument that contains an embedded derivative that would otherwise require bifurcation in accordance with SFAS No. 133 *, Accounting for Derivative Instruments and Hedging Activities* . The statement is effective as of January 1, 2007, with earlier adoption permitted. Management will evaluate whether SFAS No. 155 will have an impact on the Company's results of operations and financial condition.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* . This statement clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of adopting SFAS No. 157 on its financial statements.

In September 2006, the SEC issued SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* . SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. SAB No. 108 becomes effective during the Company's 2007 fiscal year and the Company does not expect the adoption of SAB No. 108 to have a material impact on its financial statements.

NOTE 3: ACQUISITIONS AND INTANGIBLE ASSETS

Pathlore Acquisition

On October 4, 2005, SumTotal Systems acquired Pathlore, a leading provider of Internet eLearning infrastructure software products and services for the delivery and administration of organizational learning. The merger reinforces SumTotal Systems' position as the largest worldwide software provider in the emerging learning and performance management market and is expected to provide its collective customers even greater resources for support and product innovation.

The acquisition has been accounted for under the purchase method of accounting in accordance with SFAS No. 141, *Business Combinations.* Assets acquired and liabilities assumed were recorded at their estimated fair values as of October 4, 2005. The total purchase price is $52,917,000, and is comprised of (in thousands):

Cash consideration for common and preferred stockholders and stock option holders	$ 29,286
Fair value of common stock assumed to be issued (1)	18,240
SumTotal Systems vested stock options to be issued (2)	246
Contractual change of control payments	3,698
Estimated acquisition related costs (3)	2,067
Amount receivable from Pathlore acquisition escrow account	(620)
Total consideration	$ 52,917

(1) The stockholders of Pathlore received $29,286,000 in net cash consideration and 3,999,980 shares of SumTotal Systems' common stock. The fair value of SumTotal Systems' shares assumed to be issued is based on a per share value of $4.56, which is equal to SumTotal Systems' average of the last sale price per share as reported on the National Association of Securities Dealers Automated Quotations ("NASDAQ") National Market for the trading-day period beginning two days before and ending two days after August 3, 2005, the date of announcement of the acquisition.

(2) SumTotal Systems vested stock options issued were valued at $267,000 using the Black-Scholes valuation model assuming no dividend yield, a volatility of 105.53%, a risk free interest rate of 4.09% and expected lives of options of one year. Of the $267,000, $21,000 represents stock-based compensation expense in 2005 and was not included in the purchase price above.

(3) The acquisition related costs consist primarily of banking, legal and accounting fees and other directly related costs.

The total purchase consideration has been allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective fair values at the acquisition date and resulting in excess purchase consideration over the net tangible liabilities and identifiable intangible assets acquired of $34.6 million. The following condensed balance sheet data presents the fair value of the assets and liabilities acquired (in thousands):

Assets acquired:	
Cash and cash equivalents	$ 3,282
Restricted cash	80
Accounts receivable	5,690
Prepaid expenses and other assets	420
Equipment and improvements, net	463
Goodwill	34,647
Identifiable Intangible assets	20,530
Other assets	173
	65,285
Liabilities assumed:	
Accounts payable	(1,008)
Accrued liabilities	(1,563)
Restructuring accrual	(1,488)
Deferred revenue	(4,028)
Notes payable	(2,035)
Provision for litigation settlement	(620)
Other liabilities	(1,626)
	(12,368)
Total consideration	$ 52,917

Goodwill of $34.6 million, representing the excess of the purchase price over the estimated fair value of net tangible assets and identifiable intangible assets acquired in the acquisition, will not be amortized, but is instead tested for impairment at least annually, consistent with the guidance in SFAS No. 142, *Goodwill and Other Intangible Assets* . In addition, a portion of the purchase price was allocated to the following identifiable intangible assets (in thousands, except years):

	Purchase Price	Estimated Weighed Average Useful Lives in Years
Core and developed technologies	$ 1,470	4.00
Customer installed-base relationships	12,330	6.00
Customer backlog	5,750	4.00
Non-compete covenant	980	1.50
	$20,530	5.08

The results of operations of Pathlore since October 4, 2005 are included in SumTotal Systems' statement of operations.

On March 14, 2006, SumTotal Systems entered into an agreement to settle all patent infringement claims with IpLearn, LLC that included, among other terms, a binding mutual release of all claims the parties may have had against each other, certain licenses and covenants not to sue, a payment from SumTotal Systems to IpLearn of $3.5 million, payable over three years, and the issuance of 50,000 shares of SumTotal Systems' common stock to IpLearn. The settlement was reached with no admission of liability or wrongdoing by any party. Refer to Note 11 " *Legal Proceedings* " in the Notes to the unaudited Condensed Consolidated Financial Statements.

Docent Acquisition

On March 18, 2004, Click2learn acquired Docent, a leading provider of integrated applications, services and content solutions proven to directly drive business performance through learning, and formed SumTotal Systems. The reasons for the acquisition included the belief that the combined company will be a strong, viable leader in the business performance and learning management software industry, with increased financial strength and operational efficiencies.

On March 18, 2004, stockholders of Click2learn received 0.3188 shares of common stock in SumTotal Systems for each common share of Click2learn held, or approximately 52% of the then total outstanding common stock of SumTotal Systems, without taking into account the exercise of options prior to the closing date. On March 18, 2004, stockholders of Docent received 0.7327 shares of common stock in SumTotal Systems for each common share of Docent held, or approximately 48% of the total outstanding common stock of SumTotal Systems, without taking into account the exercise of options prior to the closing date. Outstanding options and warrants were converted into options and warrants for the purchase of shares in SumTotal Systems in accordance with the same exchange ratios. The transaction was accounted for as an acquisition of Docent by Click2learn under the purchase method of accounting in accordance with SFAS No. 141, *Business Combinations* .

The total purchase consideration consisted of the following (in thousands):

Fair value of SumTotal Systems' common stock issued (4)	$ 55,663
Acquisition related costs (5)	2,120
SumTotal Systems' stock options granted (6)	9,252
	$ 67,035

(4) The fair value of SumTotal Systems' common stock issued represents 9,748,102 shares of SumTotal Systems issued for Docent's common stock outstanding on March 18, 2004, with a value of $5.71 per share. The $5.71 per share is equal to Click2learn's average last sale price per share as reported on the NASDAQ National Market for the trading-day period two days before and after October 20, 2003, the date of the merger agreement, using the exchange ratio of 0.3188.

(5) The acquisition related costs consisted of banking, legal and accounting fees, printing costs and other directly related charges.

(6) SumTotal Systems' stock options granted in exchange for Docent stock options were valued at $9.3 million using the Black-Scholes valuation model assuming no dividend yield, volatility from 0.9205 to 1.2923, risk free interest rate from 1.25% to 2.26% and expected lives of options ranging from 1.05 years to 3.2 years. The intrinsic value of unvested stock options was $2.1 million that will be amortized over the remaining vesting periods. The $2.1 million of deferred stock-based compensation represents the unearned portion, as of December 31, 2003, of the intrinsic value of Docent's common stock options assumed in the acquisition. The deferred stock-based compensation is being amortized on an accelerated basis over the remaining vesting periods of one to four years consistent with the graded vesting approach described in FIN No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* . Unvested stock options held by certain directors and officers of both Click2learn and Docent were entitled to accelerated vesting as a result of the transaction.

The total purchase consideration has been allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective fair values at the acquisition date and resulting in excess purchase consideration over the net tangible and identifiable intangible assets acquired of $24.8 million. The following condensed balance sheet data presents the fair value of the assets and liabilities acquired (in thousands):

Assets acquired:	
Cash and cash equivalents	$27,552
Short-term investments	501
Accounts receivable	5,841
Prepaid expenses and other current assets	920
Property and equipment	2,021
Intangible assets	11,257
Other assets	414
In-process research and development	1,326
Goodwill	24,782
	74,614
Deferred stock-based compensation	2,085
Liabilities assumed:	
Accounts payable and accrued liabilities	(6,578)
Restructuring accrual	(800)
Deferred revenue	(2,286)
	(9,664)
Total consideration	$67,035

Goodwill of $24.8 million, representing the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired in the acquisition, will not be amortized, but is instead tested for impairment at least annually, consistent with the guidance in SFAS No. 142, *Goodwill and Other Intangible Assets* . In addition, a portion of the purchase price was allocated to the following identifiable intangible assets (in thousands, except years):

	Purchase Price	Estimated Weighed Average Useful Lives in Years
Core and developed technologies	$ 5,413	4.00
Customer installed-base relationships	2,605	6.00
Customer hosted relationships	1,014	5.00
Customer contract relationships	2,225	1.00
	$11,257	3.96

SumTotal Systems assigned $1.3 million to acquired In-Process Research and Development (“IPR&D”) that had not yet reached technological feasibility and had no alternative future use. SumTotal Systems wrote off these assets at the date of acquisition in accordance with FIN No. 4, *Applicability of FASB No. 2, Business Combinations Accounted for by the Purchase Method* . To estimate the value of the IPR&D, the expected cash flows attributed to the completed portion of the IPR&D were calculated. These cash flows considered the contribution of the core and developed technologies, the risks related to the development of the IPR&D and the percent complete as of the valuation date as well as the expected life cycle of the technology. Finally, the cash flows attributed to the completed portion of the IPR&D, net of the core and developed technologies contribution, were discounted to their present value, using a discount rate of 25%, to estimate the value of the IPR&D. These projects were completed as part of the releases of SumTotal Suite 7.0 and 7.1 in December 2004 and April 2005, respectively.

NOTE 4: GOODWILL AND INTANGIBLE ASSETS

Goodwill represents the excess of costs over the net fair value of net identifiable 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.

Goodwill and intangible assets at September 30, 2006 and December 31, 2005 are as follows (in thousands):

	September 30, 2006		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Goodwill	$ 62,739	$ (433)	$ 62,306
Intangible assets:			
Acquired technology	$ 11,122	$ (7,842)	$ 2,899
Customer installed-base relationships	15,384	(3,621)	11,763
Customer hosted relationships	1,014	(514)	500
Customer contract relationships	7,975	(4,341)	3,634
Non-compete covenant	980	(657)	323
	$ 36,475	$ (16,975)	$ 19,119

	December 31, 2005		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Goodwill	$ 62,739	$ (433)	$ 62,306
Intangible assets:			
Acquired technology	$ 11,122	$ (6,372)	$ 4,750
Customer installed-base relationships	15,384	(1,284)	14,100
Customer hosted relationships	1,014	(361)	653
Customer contract relationships	7,975	(2,471)	5,504
Non-compete covenant	980	(282)	698
	$ 36,475	$ (10,770)	$ 25,705

There was no impairment of goodwill or intangible assets for the nine-months ended September 30, 2006 and 2005.

The following represents the expected future amortization of intangible assets as of September 30, 2006 (in thousands):

	Amortization
Remainder of 2006	$ 2,090
2007	7,194
2008	4,593
2009	2,979
2010	1,470
2011	793
	$ 19,119

Amortization expense related to intangible assets was approximately $2.1 million and $0.7 million in the three-months ended September 30, 2006 and 2005, respectively, and approximately $6.6 million and $2.8 million in the nine months-ended September 30, 2006 and 2005, respectively.

NOTE 5: BANK CREDIT FACILITY

Concurrent with the closing of the Pathlore Acquisition on October 4, 2005, SumTotal Systems entered into a credit facility with Wells Fargo Foothill, principally to fund a portion of the acquisition price, and to provide for its ongoing working capital requirements. Under the terms of the facility, Wells Fargo Foothill loaned SumTotal Systems $17.5 million to complete the acquisition of Pathlore (the “Term Loan”) and provided a revolving credit facility to a maximum of $5.0 million (the “Revolver”) to meet the working capital requirements of the business.

The amounts outstanding bear interest at Wells Fargo Foothill’s base rate plus 2%, unless SumTotal Systems elects to be charged at the London Interbank Offered rate (“LIBOR”) rate plus 3.5%. As of September 30, 2006, SumTotal Systems has elected to be charged at the LIBOR rate, which was 5.37% on September 30, 2006 resulting in a total interest rate of 8.87%. The Term Loan is due in installments of $1,093,750 quarterly commencing January 1, 2006 and is secured by SumTotal Systems’ assets. The Term Loan and any remaining balance on the Revolver are due and payable on October 5, 2009. Any interest due on the Revolver must be paid at least every three months.

The Term Loan is subject to certain restrictive covenants which include, but are not limited to, maintaining certain levels of earnings before interest, taxes, depreciation and amortization (“EBITDA”), leverage ratios, as well as restrictions on capital expenditures, indebtedness, distributions, investments, and on 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 September 30, 2006, SumTotal Systems had $20.7 million comprising $15.7 million in qualified cash accounts and $5.0 million in excess availability under the revolver and therefore no test of the covenants was required. During July 2006, SumTotal Systems entered into an agreement with Wells Fargo Bank in which SumTotal Systems will enter into forward foreign exchange contracts to mitigate certain foreign exchange exposures the Company has related to foreign trade receivables. As part of this agreement the credit facility provides for a 5% reserve against the Revolver. As a result of the 5% reserve requirement SumTotal will have $250,000 less in funds available for use including debt covenant compliance, under the Revolver. Prospectively, at this time, SumTotal Systems anticipates it will only enter into forward foreign exchange hedging contracts to mitigate foreign currency exposures and will not enter into forward foreign exchange contracts for trading or speculative purposes.

In the event that SumTotal Systems’ qualified cash balance falls below the $15.0 million threshold and it cannot achieve the financial results necessary to maintain compliance with these covenants, SumTotal Systems could be declared in default and be required to sell or liquidate its assets to repay outstanding debt of approximately $14.2 million. In accordance with the terms of the Term Loan, during the nine months ended September 30, 2006, SumTotal made total payments of $4.2 million to Wells Fargo Foothill of which $3.3 million and $0.9 million were principal and interest, respectively.

NOTE 6: RESTRUCTURING

The following table depicts this restructuring activity for the nine-months ended September 30, 2006 (in thousands):

	December 31, 2005	Restructuring Charge	Cash Expenditures	September 30, 2006
Vacated facilities	$ 1,662	$ 68	$ (923)	$ 807
Employee severance	742	—	(666)	76
Other	235	—	(91)	144
Total	$ 2,639	$ 68	$ (1,680)	$ 1,027

The facility accruals were originally established at the combined net present value of lease payments, common area maintenance charges, estimated sublease income, and estimated sublease commission costs.

Accrued amounts for vacated facilities were paid over the lease terms of Framingham, Massachusetts (lease ended in January 2006), and Cupertino, California (lease ended in August 2006). Accrued amounts for vacated facilities are being paid over the lease term of Bellevue, Washington and Chicago, Illinois facilities, which will end December 2008 and May 2010, respectively, except as described in the following paragraph.

Fiscal 2006

Subsequent to September 30, 2006, SumTotal Systems negotiated what is expected to be a final lease termination agreement for its Chicago facility in which, for a lump sum payment of approximately $658,000, SumTotal Systems will effect a cancellation of the lease. The difference between the net remaining estimated lease liability and the termination settlement amount of $658,000 resulted in an accrual of $68,000 that has been accrued at September 30, 2006 as a restructuring charge in the third quarter of 2006. In addition, the entire Chicago-related accrual is reflected as a current liability as of September 30, 2006.

Fiscal 2005

During the fourth quarter of fiscal 2005, SumTotal Systems recorded a $358,000 restructuring charge which coincided with the acquisition of Pathlore. The restructuring consisted of $72,000 in employee severance costs and $286,000 in facility exit costs, which were subsequently paid in the first quarter of fiscal 2006. Employee severance costs consisted of severance and other benefits resulting from a reduction of one service and maintenance employee, four sales and marketing employees and one general and administrative employee. Facility exit costs represented the fair value of the lease liabilities relating to the closure of a facility in London, United Kingdom, based on the amount of $314,000 agreed with the former landlord in January of 2006 to settle this commitment less $28,000 previously accrued.

In October 2005, a portion of the Pathlore purchase price was allocated to $1,363,000 in employee severance costs and $1,512,000 to accrue future building lease commitments for buildings in Chicago, Illinois and Cupertino, California that were closed in October 2005, net of future estimated sublease income and $239,000 for a non-compete agreement on Pathlore's books at the time of acquisition.

In November 2005, SumTotal Systems reversed $42,000 from the restructuring accrual and re-entered a part of the facility in Bellevue, Washington which was previously restructured.

NOTE 7: COMMITMENTS AND CONTINGENCIES

SumTotal Systems leases office space and certain equipment under non-cancelable operating leases expiring in years through 2013. Rent expense under operating leases was approximately $624,000 and $575,000 during the three-months ended September 30, 2006 and 2005, respectively. Rent expense under operating leases was approximately $1,993,000 and $1,802,000 during the nine-months ended September 30, 2006 and 2005, respectively.

As discussed in Note 6, obligations for restructured facility leases are accrued on the balance sheet at their net present values including estimated future sublease rentals.

In October 2005, retention bonuses were granted to certain officers of SumTotal Systems. These bonuses will be paid in two equal amounts in October 2006 and 2007, assuming the affected individuals are still employed by SumTotal Systems, and are being accrued ratably over the performance period. On February 10 2006, SumTotal Systems entered into a separation, release and consulting agreement with Kevin Oakes in connection with his resignation as President of SumTotal Systems, effective May 31, 2006. As a result of this agreement, he will receive his retention bonus of $480,000 no later than January 12, 2007.

SumTotal Systems has entered into various arrangements with hosting services vendors with original periods expiring through 2007.

NOTE 8: GUARANTEES, WARRANTIES AND INDEMNIFICATION

SumTotal Systems has adopted FIN No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* . FIN No. 45 provides expanded accounting guidance surrounding liability recognition and disclosure requirements related to guarantees. In the ordinary course of business, SumTotal Systems is not subject to potential obligations under guarantees that fall within the scope of FIN No. 45 except for standard indemnification and warranty provisions that are contained within many of its customer license and service agreements and give rise only to the disclosure requirements prescribed by FIN No. 45 .

Indemnification and warranty provisions contained within SumTotal Systems' customer license and service agreements are generally consistent with those prevalent in the industry. The duration of product warranties are generally between 90 to 365 days following delivery of the products. Significant obligations under customer indemnification or warranty provisions have not been incurred historically and are not expected in the future. Accordingly, accruals for potential customer indemnification or warranty-related obligations are not maintained.

SumTotal Systems has entered into indemnification agreements with its directors and certain of its officers that will require SumTotal Systems, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. SumTotal Systems has also agreed to indemnify certain former officers, directors and employees of acquired companies in connection with the acquisition of such companies. SumTotal Systems maintains director and officer insurance, which may cover certain liabilities arising from its obligation to indemnify its directors and officers and former directors, officers and employees of acquired companies, in certain circumstances.

NOTE 9: SEGMENT INFORMATION

SFAS No. 131, *Disclosure about Segments of an Enterprise and Related Information* , requires that companies report separately in the financial statements certain financial and descriptive information about operating segments profit or loss, certain specific revenue and expense items and segment assets. The method for determining what information is reported is based on the way that management organizes the operating segments for making operational decisions and assessments of financial performance. SumTotal Systems' chief operating decision maker is considered to be the CEO. The CEO reviews financial information presented on a consolidated basis for purposes of making operating decisions and assessing financial performance. The consolidated financial information reviewed by the CEO is similar to the information presented in the accompanying unaudited condensed consolidated financial statements of operations. Currently, management does not use product line or geographic financial performance as a basis for business operating decisions. Therefore, SumTotal Systems has determined that it operates in a single reportable segment.

Revenues by geographic region which are based on the location of the customers are as follows for the three-months and nine-months ended September 30, 2006 and 2005 (in thousands):

	Three-Months Ended September 30,		Nine-Months Ended September 30,	
	2006	2005	2006	2005
United States	$22,395	$13,558	$60,973	$37,850
Other Americas	1,011	1,197	3,161	2,484
Total Americas	23,406	15,206	64,134	40,334
Europe	2,724	2,639	9,322	8,446
Asia/Pacific	824	1,015	2,904	2,256
	$26,954	$18,409	$76,360	$51,036

For the three-months ended September 30, 2006 and 2005, international revenues for SumTotal Systems accounted for approximately 17% and 26%, respectively, of total revenues. For the nine-months ended September 30, 2006 and 2005, international revenues for SumTotal Systems accounted for approximately 20% and 26%, respectively, of total revenues.

No customer accounted for greater than 10% of SumTotal Systems' total consolidated revenues in the three-months or nine-months ended September 30, 2006 or 2005 except for one customer which accounted for 15% of SumTotal Systems' total consolidated revenues in the three-months ended September 30, 2005.

No customer accounted for greater than 10% of SumTotal Systems' accounts receivable, net of allowance for sales returns and doubtful accounts at September 30, 2006.

Long-lived assets, which represent property, plant and equipment, goodwill and intangible assets, net of accumulated depreciation and amortization, by geographic location are as follows (in thousands):

	September 30, 2006	December 31, 2005
United States	$ 84,832	$ 90,347
Europe	274	292
India	1,640	929
Asia/Pacific	34	653
	$ 86,780	$ 92,221

NOTE 10: LEGAL SETTLEMENT

On March 14, 2006, SumTotal Systems entered into an agreement to settle all patent infringement claims with IpLearn, LLC that included, among other terms, a binding mutual release of all claims the parties may have had against each other, certain licenses and covenants not to sue, a payment from SumTotal Systems to IpLearn of $3.5 million, payable over three years, and the issuance of 50,000 shares of SumTotal Systems' common stock to IpLearn. The settlement was reached with no admission of liability or wrongdoing by any party. As a result of the settlement agreement, SumTotal Systems recorded a charge of $2.7 million in 2005 based on the estimated present value of the total amount owed of $3.3 million, net of $0.6 million recoverable from the escrow account established in connection with the Pathlore acquisition. The $3.3 million is recorded on the December 31, 2005 balance sheet, as a $1.0 million current liability and a $2.3 million non-current liability and the $0.6 million recoverable from the escrow account is recorded in other current assets. During the second quarter of 2006, SumTotal Systems received the $0.6 in escrow funds that were recorded in other current assets. The September 30, 2006 current and non-current liability balances were $1.0 million and $1.6 million, respectively.

NOTE 11: LEGAL PROCEEDINGS

From time-to-time, we are involved in legal proceedings or threats of legal proceedings arising in the ordinary course of business. We are not currently a party to any litigation or other legal proceeding that, in the opinion of management, is reasonably likely to have a material adverse effect on our business, operating results and financial condition.

Refer to Note 10 *"Legal Settlement"* in the Notes to the unaudited Condensed Consolidated Financial Statements for additional detail.

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

Executive Summary

During the quarter ended September 30, 2006, we continued to implement our business strategy of (1) growing the core business at a rate higher than industry growth, (2) growing an Original Equipment Manufacturer ("OEM") business as an incremental growth opportunity for the Company and (3) expanding our application reach to include more of the talent management market through partnerships, internal startups and strategic mergers and acquisitions. Much of our efforts for the latter two objectives are still in the planning and early implementation stages and the results of the quarter and nine-months ended September 30, 2006 reflect the success of the first business strategy.

Revenue increased to $27.0 million compared to $18.4 million in the same quarter one year ago. This reflects our success in acquiring new customers and selling additional licenses and services into our installed base including customers acquired as part of the purchase of Pathlore Software Corporation on October 4, 2005.

Gross margin increased to $14.7 million compared to $12.1 million in the same quarter one year ago. Despite the increase in absolute dollars gross margin percentage declined from 66% a year ago to 55% in the third quarter. The factors that contributed to this were: the additional amortization expense of acquired intangible assets associated with the acquisition of Pathlore resulted in increased amortization expense of $1.3 million; increased expenses associated with hiring additional service personnel to support both the legacy Pathlore installed base and the SumTotal installed base; increased stock-based compensation expenses of $0.2 million as a result of implementing SFAS No. 123(R) , *Share-Based Payments* in 2006 as compared to the year ago quarter; and certain one-time costs of $0.3 million related to a customer satisfaction and remediation program aimed at reducing future long-term support costs. Going forward, as we renew former Pathlore support contracts at full value and realize the expected costs savings from our customer satisfaction program we believe that the margin should improve.

Operating expenses increased from $12.0 million in the year ago quarter to $17.1 million in the third quarter, or 42%. The increase was primarily related to increased expenses from research and development activities of $1.5 million, increased sales and marketing expenses of $2.2 million, and increased general and administrative expenses of $1.3 million. Included in these increases were increased stock-based compensation expenses of $0.6 million as a result of implementing SFAS No. 123(R) , *Share-Based Payments* in 2006 as compared to the year ago quarter, and one-time charge in the current year's quarter of approximately $0.3 million related to our sponsorship of a marketing and trade show event. The remainder of the increase was primarily related to additional costs required to support the addition of the Pathlore business and our other business growth initiatives.

As a result of the decrease in the third quarter's gross margin and the increases in operating expenses, net loss for the quarter was $2.7 million compared to net income of $0.1 million in the third quarter of 2005. Despite this, cash generated from operations was $3.6 million for the nine months ended September 30, 2006, compared to $0.9 million for the comparable period a year ago, and we continue to generate positive cash flow from operations.

The balance sheet at September 30, 2006 remained comparable to the year-end balance sheet. Accounts receivable, net reduced from $25.2 million at December 31, 2005 to $23.2 million as of September 30, 2006 as a result of good collections, and we continued to make payments on the litigation and restructuring accruals and pay our quarterly Wells Fargo Foothill debt repayments of $3.3 million during 2006.

Critical Accounting Policies and Estimates

In most cases, the accounting treatment of a particular transaction is specifically dictated by accounting principles generally accepted in the U.S. and does not require management's judgment in its application. However, certain of our accounting policies require the application of significant judgment by management in selecting the appropriate assumptions for calculating financial estimates. By their nature, these judgments are subject to an inherent degree of uncertainty. These judgments reflect practices, information provided by our customers and other assumptions that we believe are reasonable under the circumstances. Our estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the unaudited condensed consolidated financial statements in the period in which they are determined to be necessary. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies and estimates include:

- revenue recognition;

- estimating allowances for sales returns and the allowance for doubtful accounts;
- recoverability evaluation of our goodwill and intangible assets;
- restructuring;
- valuation reserve for deferred tax assets;
- business combination; and
- stock-based compensation.

Our senior management has reviewed these critical accounting policies and related disclosures with our Disclosure Committee and the Audit Committee of our Board of Directors. Refer to the Notes to the Unaudited Condensed Consolidated Financial Statements, which contain additional information regarding our accounting policies and other disclosures required by GAAP.

Stock-based Compensation Expense

On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment* , (“SFAS No. 123(R)”) which establishes standards for the accounting of transactions in which an entity exchanges its equity instruments for goods or services, primarily focusing on accounting for transactions where an entity obtains employee services in share-based payment transactions. SFAS No. 123(R) requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments, including stock options, based on the grant-date fair value of the award and to recognize it as compensation expense over the period the employee is required to provide service in exchange for the award, usually the vesting period. SFAS No. 123(R) supersedes the Company’s previous accounting under Accounting Principles Board Opinion (“APB”) No. 25, *Accounting for Stock Issued to Employees* for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin (“SAB”) No. 107 relating to SFAS No. 123(R). The Company has applied the provisions of SAB No. 107 in its adoption of SFAS 123(R).

The Company adopted SFAS No. 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company’s fiscal year 2006. The Company’s unaudited condensed consolidated financial statements as of and for the three and nine-months ended September 30, 2006 reflect the impact of SFAS No. 123(R). In accordance with the modified prospective transition method, the Company’s unaudited condensed consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123(R).

We have had no other significant changes in our critical accounting policies and estimates since our previous filing on our Annual Report on Form 10-K, as filed with the SEC on March 28, 2006.

Results of Operations

The following table presents our results of continuing operations as a percentage of total revenue for the three-months and nine-months ended September 30, 2006 and 2005:

	Three-Months Ended September 30,		Nine-Months Ended September 30,	
	2006	2005	2006	2005
Revenue:				
License	26.6%	36.0%	28.8%	33.9 %
Service and maintenance	73.4	64.0	71.2	66.1
Total revenue	100.0	100.0	100.0	100.0
Cost of revenue:				
License and amortization of intangible assets	8.9	5.1	9.5	7.7
Service and maintenance	36.5	29.2	35.7	30.1
Total cost of revenue	45.4	34.3	45.2	37.8
Gross margin	54.6	65.7	54.8	62.2
Operating expenses:				
Research and development	17.0	16.7	16.6	17.4
Sales and marketing	29.2	30.8	29.8	34.9
General and administrative	17.0	17.9	19.8	21.4
Restructuring charge	0.3	—	0.1	—
Total operating expenses	63.5	65.4	66.3	73.7
Net income (loss) from operations	(8.9)	0.3	(11.5)	(11.5)
Other income (expense), net	(1.1)	0.6	(0.8)	0.2
Net income (loss) before income taxes	(10.0)	0.9	(12.3)	(11.3)
Provision for income taxes	0.0	0.2	0.0	0.2
Net income (loss)	(10.0)%	0.7%	(12.3)%	(11.5)%

Revenue

Net sales, which include product and service revenue, for each region are summarized in the following tables (in thousands, except percentages):

Comparison of Revenue by Region for the Three-Months Ended September 30, 2006 and 2005

	Three-Months Ended			
	September 30, 2006	September 30, 2005	Variance in Dollars	Variance in Percent
Revenue				
United States	$ 22,395	$ 13,558	$ 8,837	65.2%
Percentage of net revenue	*83.1 %*	*73.6 %*		
Other Americas	1,011	1,197	(186)	(15.5)%
Percentage of net revenue	*3.8 %*	*6.5 %*		
Americas	23,406	14,755	8,651	58.6%
Percentage of net revenue	*86.8 %*	*80.2 %*		
Europe	2,724	2,639	85	3.2%
Percentage of net revenue	*10.1 %*	*14.3 %*		
Asia/Pacific	824	1,015	(191)	(18.8)%
Percentage of net revenue	*3.1 %*	*5.5 %*		
Total	$ 26,954	$ 18,409	$ 8,545	46.4%

In the three-months ended September 30, 2006, revenue from the Americas grew $8.7 million and accounted for approximately 87% of the total revenue all of the growth. Approximately $3.8 million of the increase is the result of the Pathlore acquisition in the fourth quarter of 2005, and another $4.9 million or 33% growth is the result of continued strong sales of the SumTotal 7.x product suite and related services.

Comparison of Revenue by Region for the Nine-Months Ended September 30, 2006 and 2005

	Nine-Months Ended			
	September 30, 2006	September 30, 2005	Variance in Dollars	Variance in Percent
Revenue				
United States	$ 60,973	$ 37,850	$ 23,123	61.1%
Percentage of net revenue	*79.8 %*	*74.2 %*		
Other Americas	3,161	2,484	677	27.3%
Percentage of net revenue	*4.1 %*	*4.9 %*		
Americas	64,134	40,334	23,800	59.0%
Percentage of net revenue	*84.0 %*	*79.0 %*		
Europe	9,322	8,446	876	10.4%
Percentage of net revenue	*12.2 %*	*16.5 %*		
Asia/Pacific	2,904	2,256	648	28.7%
Percentage of net revenue	*3.8 %*	*4.4 %*		
Total	$ 76,360	$ 51,036	$ 25,324	49.6%

In the nine-months ended September 30, 2006, revenue from the Americas accounted for approximately 84% of the total revenue and 94% of the total growth. Approximately $12.0 million of the increase is the result of the Pathlore acquisition in the fourth quarter of 2005, and another $11.8 million or 29% growth is the result of continued strong sales of the SumTotal 7.x product suite and related services.

No customer accounted for greater than 10% of SumTotal Systems' total consolidated revenues in the three-months or nine-months ended September 30, 2006 or 2005 except for one customer which accounted for 15% of SumTotal Systems' total consolidated revenues in the three-months ended September 30, 2005.

The following tables summarize revenue between licenses and service and maintenance (in thousands, except percentages):

Comparison of License and Service and Maintenance Revenue for the Three-Months Ended September 30, 2006 and 2005

	Three-Months Ended			
	September 30, 2006	September 30, 2005	Variance in Dollars	Variance in Percent
Revenue:				
License	$ 7,169	$ 6,629	$ 540	8.1%
Percentage of net revenues	*26.6 %*	*36.0 %*		
Service and maintenance	19,785	11,780	8,005	68.0%
Percentage of net revenues	*74.3 %*	*64.0 %*		
Total	$ 26,954	$ 18,409	$ 8,545	46.4%

License revenue Approximately $0.5 million of the increase is the result of the Pathlore acquisition in the fourth quarter of 2005.

We had $2.8 million in deferred license revenue at September 30, 2006 consisting of numerous contracts that should mostly become recognizable as revenue over the next three to six months.

Service and maintenance revenue. Service and maintenance revenue in the three-months ended September 30, 2006 and 2005 consisted of the following (in thousands):

	Three-Months Ended			
	September 30, 2006	September 30, 2005	Variance in Dollars	Variance in Percent
Maintenance	$ 7,981	$ 5,043	$ 2,938	58.3%
Hosting	2,952	1,994	958	48.0%
Training	1,291	1,014	277	27.3%
Consulting	6,950	3,615	3,335	92.3%
Application service provider	611	114	497	436.0%
	$ 19,785	$ 11,780	$ 8,005	68.0%

Approximately $3.4 million of the increase to service and maintenance revenue is the result of the Pathlore acquisition in the fourth quarter of 2005, and another $4.6 million from service contracts related to the SumTotal 7.x product suite.

$2.7 million of the increase to maintenance revenue was due to the Pathlore acquisition and another $0.3 million from maintenance contracts related to the SumTotal 7.x product suite.

$0.4 million of the increase in hosting revenue was due to the Pathlore acquisition and $0.6 million from hosting contracts related to the SumTotal 7.x product suite..

A nominal amount of the increase in training revenue was due to the Pathlore acquisition and $0.3 million from training contracts related to the SumTotal 7.x product suite.

$0.3 million of the increase in consulting revenue was due to the Pathlore acquisition and $3.1 million from consulting contracts related to the SumTotal 7.x product suite.

Price changes in service and maintenance revenue had no material effect on the three-months ended September 30, 2006 compared to the same period in 2005.

Comparison of License and Service and Maintenance Revenue for the Nine-Months Ended September 30, 2006 and 2005

	Nine-Months Ended			
	September 30, 2006	September 30, 2005	Variance in Dollars	Variance in Percent
Revenue:				
License	$ 22,014	$ 17,286	$ 4,728	27.4%
Percentage of net revenues	*28.8 %*	*33.9 %*		
Service and maintenance	54,346	33,750	20,596	61.0%
Percentage of net revenues	*71.2 %*	*66.1 %*		
Total	$ 76,360	$ 51,036	$ 25,324	49.6%

License revenue. In the nine-months ended September 30, 2006, license revenue increased $4.7 million, or 27%, to $22.0 million, from $17.3 million in the comparable period in 2005. Approximately $2.4 million of the increase is the result of the Pathlore acquisition in the fourth quarter of 2005, and another $2.3 million from license contracts from the SumTotal 7.x product suite.

Service and maintenance revenue. Service and maintenance revenue in the nine-months ended September 30, 2006 and 2005 consisted of the following (in thousands):

	Nine-Months Ended			
	September 30, 2006	September 30, 2005	Variance in Dollars	Variance in Percent
Maintenance	$ 22,421	$ 13,557	8,864	65.4%
Hosting	8,384	5,712	2,672	46.8%
Training	3,369	2,530	839	33.2%
Consulting	18,816	11,536	7,280	63.1%
Application service provider	1,356	415	941	226.7%
	$ 54,346	$ 33,750	$ 20,596	61.0%

Approximately $9.9 million of the increase in service and maintenance revenue is the result of the Pathlore acquisition in the fourth quarter of 2005, and another $10.6 million or 28% from service contracts related to the SumTotal 7.x product suite.

$6.7 million of the increase in maintenance revenue was due to the Pathlore acquisition and $2.1 million from maintenance contracts related to the SumTotal 7.x product suite.

$1.2 million of the increase in hosting revenue was due to the Pathlore acquisition and another $1.5 million from hosting contracts related to the SumTotal 7.x product suite.

$0.1 million of the increase in training revenue was due to the Pathlore acquisition and another $0.8 million from training contracts related to the SumTotal 7.x product suite.

$1.8 million of the increase in consulting revenue was due to the Pathlore acquisition and another $5.5 million from consulting contracts related to the SumTotal 7.x product suite.

Price changes in service and maintenance revenue had no material effect on the nine-months ended September 30, 2006 compared to the same period in 2005.

Cost of Revenue

The following tables are a summary of cost of revenue between license, service and maintenance, and amortization of intangible assets (in thousands, except percentages):

Comparison of Cost of Revenue for the Three-Months Ended September 30, 2006 and 2005

	Three-Months Ended			
	September 30, 2006	September 30, 2005	Variance In Dollars	Variance in Percent
Cost of revenue				
License	$ 289	$ 212	$ 77	36.3%
Percentage of net revenues	*1.1 %*	*1.2 %*		
Service and maintenance	9,849	5,368	4,481	83.5%
Percentage of net revenues	*36.5 %*	*29.2 %*		
Amortization of acquired intangible assets	2,090	742	1,348	181.7%
Percentage of net sales	*7.8 %*	*4.0 %*		
Total	$ 12,228	$ 6,322	$ 5,906	93.4%

Approximately $1.6 million of the increase is related to the amortization of Pathlore acquired intangibles offset by reduced intangible amortization of $0.2 million from prior year.

The overall increase also included $0.2 million increase in stock-based compensation amortization expense due to the adoption of SFAS No. 123 (R) in the 2006 year, and $0.3 million related to a customer satisfaction program designed to reduce future ongoing support costs.

Cost of license. Our cost of license revenue consists primarily of the cost of third party software content we resell and is related to legacy SumTotal sales.

Cost of service and maintenance. Expenses relating to service and maintenance personnel in the three-months ended September 30, 2006, increased $2.1 million or 70%, to $5.1 million from $3.0 million in the comparable period in 2005, due to increased salary costs of $0.7 million for an additional 30 personnel as a result of the Pathlore acquisition, additional staffing of 24 in India of $0.2 million and $1.1 million for an additional 29 in the rest of the world. Consulting expenses in the three-months ended September 30, 2006, increased by $0.5 million from the comparable period in 2005. Travel expenses associated with the increased staff in the three-months ended September 30, 2006 increased by $0.3 million from the comparable period in 2005. Facilities and equipment expenses including depreciation from new hosting equipment increased by $0.7 million from the comparable period in 2005. Costs related to third party revenue in the three-months ended September 30, 2006 increased by $0.3 million from the comparable period in 2005. Costs associated with a customer satisfaction program in the three-months ended September 30, 2006 increased by $0.3 million from the comparable period in 2005. Stock-based compensation expense in the three-months ended September 30, 2006, increased by $0.2 million from the comparable period in 2005 due to the adoption of SFAS No. 123(R).

Amortization of intangibles. Under SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed* , we capitalized certain project costs recorded after technological feasibility was established on our Virtual Classroom Server product, which is included in intangible assets on the balance sheet and is fully amortized by the end of the second quarter 2006. We recorded amortization expenses $0.2 million in the three-months ended September 30, 2005.

On October 4, 2005, we acquired Pathlore and assigned a fair value of $20.5 million to acquired intangible assets. On March 18, 2004, we acquired Docent, Inc. and assigned a fair value of $11.3 million to acquired intangibles assets. These intangible assets are being amortized over periods from one year to six years based on the estimated cash flows from the underlying assets.

Under SFAS No. 142, *Goodwill and Other Intangible Assets* , we make judgments about the recoverability of intangible assets whenever events or changes in circumstances indicate that impairment in the remaining value of the assets recorded on our balance sheet may exist. In order to estimate the fair value of intangible assets, we make various assumptions about the future prospects for the business to which the asset relates and typically estimate future cash flows to be generated by these businesses.

The increase in amortization of intangible assets for the three-months ended September 30, 2006 is due to the additional amortization of intangible assets from the acquisition of Pathlore in October 2005, of $1.6 million, offset by reduced amortization of $0.2 million from the comparable period in 2005 from the March 2004, Docent acquisition.

Table of Contents

Comparison of Cost of Revenue for the Nine-Months Ended September 30, 2006 and 2005

	Nine-Months Ended			
	September 30, 2006	September 30, 2005	Variance In Dollars	Variance in Percent
Cost of revenue				
License	$ 632	$ 1,072	$ (440)	(41.0)%
Percentage of net revenues	*0.8 %*	*2.1 %*		
Service and maintenance	27,260	15,368	11,892	77.4%
Percentage of net revenues	*35.7 %*	*30.1 %*		
Amortization of acquired intangible assets	6,586	2,841	3,745	131.8%
Percentage of net sales	*8.6 %*	*5.6 %*		
Total	$ 34,478	$ 19,281	$ 15,197	78.8%

Approximately $4.8 million of the increase is related to the amortization of Pathlore acquired intangibles offset by reduced intangible amortization of $1.1 million from prior year.

Cost of license. Our cost of license revenue includes the cost of third party software content we resell and is related to legacy SumTotal sales. The second quarter of the prior year included a large license revenue transaction which required the Company to purchase software for resale from a third party.

Cost of service and maintenance. Expenses relating to service and maintenance personnel in the nine-months ended September 30, 2006, increased $6.5 million or 75%, to $15.1 million from $8.6 million in the comparable period in 2005, due to increased salary costs of $2.2 million for an additional 30 personnel as a result of the Pathlore acquisition, additional staffing of 24 in India of $0.6 million and $3.7 million for an additional 29 in the rest of the world. Consulting expenses in the nine-months ended September 30, 2006, increased by $1.0 million from the comparable period in 2005. Travel expenses associated with the increased staff in the nine-months ended September 30, 2006 increased by $0.9 million from the comparable period in 2005. Facilities and equipment expenses including depreciation from new Hosting equipment increased by $2.2 million from the comparable period in 2005. Costs related to third party revenue in the nine-months ended September 30, 2006 increased by $0.2 million from the comparable period in 2005. Costs associated with a customer satisfaction program in the nine-months ended September 30, 2006 increased by $0.3 million from the comparable period in 2005. The remaining increase of $0.9 million was related to an increase in stock-based compensation expense of $0.7 million and increases in miscellaneous other expenses of $0.2 million in 2006 from the comparable period in 2005.

Amortization of intangibles. Under SFAS No. 86, we capitalized certain project costs recorded after technological feasibility was established on our Virtual Classroom Server product, which is included in intangible assets on the balance sheet and is fully amortized by the end of the second quarter 2006. We recorded amortization expenses of $0.3 million and $0.7 million in the nine-months ended September 30, 2006 and 2005, respectively.

On October 4, 2005, we acquired Pathlore and assigned a fair value of $20.5 million to acquired intangible assets. On March 18, 2004, we acquired Docent, Inc. and assigned a fair value of $11.3 million to acquired intangibles assets. These intangible assets are being amortized over periods from one year to six years based on the estimated cash flows from the underlying assets.

Under SFAS No. 142, we make judgments about the recoverability of intangible assets whenever events or changes in circumstances indicate that impairment in the remaining value of the assets recorded on our balance sheet may exist. In order to estimate the fair value of intangible assets, we make various assumptions about the future prospects for the business to which the asset relates and typically estimate future cash flows to be generated by these businesses.

The increase in amortization of intangible assets for the nine-months ended September 30, 2006 is due to the addition of intangible assets from the acquisition of Pathlore in October 2005, amortized at $4.8 million, offset by reduced amortization of $1.1 million from the comparable period in 2005 from the March 2004, Docent acquisition.

Table of Contents

Gross Margin

The following tables are a summary of gross margin between license and amortization of intangible assets, and service and maintenance (in thousands, except percentages):

Comparison of Gross Margin for the Three-Months Ended September 30, 2006 and 2005

	Three-months Ended	
	September 30, 2006	September 30, 2005
Gross margin		
License	$ 6,880	$ 6,417
Percentage of license revenue	*96.0 %*	*96.8 %*
Service and maintenance	9,936	6,412
Percentage of service and maintenance revenue	*50.2 %*	*54.4 %*
Amortization of intangible assets	(2,090)	(742)
Percentage of license revenue	*(29.2)%*	*(11.2)%*
Total	$ 14,726	$ 12,087
Percentage of net sales	*54.6 %*	*65.7 %*

Our cost of license revenue includes the cost of third party software content we resell and is related to legacy SumTotal sales.

The decrease in gross margin percentage for service and maintenance is due to increased headcount related to our continuing efforts to build out our service infrastructure, recurring costs to support the acquired Pathlore service revenue base but with the related service revenue carried at the written down fair value due to purchase accounting adjustments and $0.3 million in stock-based compensation charges related to the adoption of SFAS 123(R).

Comparison of Gross Margin for the Nine-Months Ended September 30, 2006 and 2005

	Nine-months Ended	
	September 30, 2006	September 30, 2005
Gross margin		
License	$ 21,382	$ 16,214
Percentage of license revenue	*97.1 %*	*93.8 %*
Service and maintenance	27,086	18,382
Percentage of service and maintenance revenue	*49.8 %*	*54.5 %*
Amortization of intangible assets	(6,586)	(2,841)
Percentage of license revenue	*(29.9)%*	*(16.4)%*
Total	$ 41,882	$ 31,755
Percentage of net sales	*54.8 %*	*62.2 %*

The lower margin in the prior year was the result of the purchase of software from a third party to support a large license revenue transaction.

The decrease in gross margin percentage for service and maintenance is due to increased headcount related to our continuing efforts to build out our service infrastructure, recurring costs to support the acquired Pathlore service revenue base but with the related service revenue carried at partial value due to purchase accounting adjustments, and other non-revenue generating cost increases including $0.8 million for stock-based compensation charges related to the adoption of SFAS 123(R).

Operating Expenses

The following tables are a summary of research and development, sales and marketing and general and administrative expenses (in thousands, except percentages):

Comparison of Operating Expenses for the Three-Months Ended September 30, 2006 and 2005

	Three-Months Ended			
	September 30, 2006	September 30, 2005	Variance in Dollars	Variance in Percent
Research and development	$ 4,572	$ 3,068	$ 1,504	49.0%
Percentage of net sales	*17.0 %*	*16.7 %*		
Sales and marketing	7,895	5,673	2,222	39.2%
Percentage of net sales	*29.3 %*	*30.8 %*		
General and administrative	4,571	3,288	1,283	39.0%
Percentage of net sales	*17.0 %*	*17.9 %*		

Restructuring charge	68	—	68	—
Percentage of net sales	*0.3 %*	—		
Total	$ 17,106	$ 12,029	$ 5,077	42.2%
Percentage of net sales	*63.5 %*	*65.3 %*		

Research and development. Expenses relating to research and development personnel in the three-months ended September 30, 2006 increased $0.8 million or 41%, to $2.8 million from $2.0 million in the comparable period in 2005, due to increased salary costs for additional personnel including those resulting from the acquisition of Pathlore, and increased staffing in India. Consulting expenses in the three-months ended September 30, 2006 increased to $0.5 million from $0.2 million in the comparable period in 2005. Additional staff and consultants were needed to support work on our product platform specifically on our next release of SumTotal 7.x. Facility and equipment expenses in the three-months ended September 30, 2006 increased to $1.0 million from $0.7 million in the comparable period in 2005. Miscellaneous expenses for recruiting and travel in the three months ended September 30, 2006 increased by $0.01 million. Stock-based compensation expense in the three-months ended September 30, 2006 increased by $0.1 million from the comparable period in 2005 due to the adoption of SFAS No. 123(R).

We expect research and development expenses to increase slightly in absolute dollars through the end of fiscal 2006 due to additional consulting services and additional hiring relating to future versions of SumTotal 7.x Series.

Sales and marketing Expenses relating to sales and marketing personnel in the three-months ended September 30, 2006 increased $1.2 million or 32%, to $5.1 million from $3.9 million in the comparable period in 2005, due to increased salary costs from additional personnel including those as a result of the acquisition of Pathlore, and higher commissions and bonus costs. Marketing programs expenses in the three-months ended September 30, 2006 increased $0.4 million from the comparable period in 2005. Travel expenses associated with increased staff in the three-months ended September 30, 2006 increased by $0.2 million from the comparable period in 2005. Miscellaneous expenses related to facilities, recruiting and other outside services in the three-months ended September 30, 2006 increased by $0.2 million from the comparable period in 2005. Stock-based compensation expense in the three-months ended September 30, 2006 increased by $0.2 million from the comparable period in 2005 due to the adoption of SFAS No. 123(R).

We expect sales and marketing expenses to increase slightly in absolute dollars due to additional personnel and commissions costs throughout the remainder of fiscal 2006.

General and administrative. For the three-months ended September 30, 2006, accounting expenses and consulting fees associated with compliance with Sarbanes-Oxley Section 404 decreased $0.4 million or 54%, to $0.3 million from $0.7 million in the comparable period in 2005. Expenses relating to general and administrative personnel in the three-months ended September 30, 2006 increased $1.1 million or 64%, to $2.9 million from $1.8 million in the comparable period in 2005. The increased costs were related to increased salaries and related expenses for additional staff to support the Pathlore acquisition of $0.5 million and increased staff to support growth in our internal infrastructure and performance related bonuses, the sum of which was $0.6 million. The remaining increase of $0.6 million was related to an increase in stock-based compensation expense of $0.3 million due to the adoption of SFAS No. 123(R) and increases in miscellaneous and other expenses of $0.3 million in 2006 from the comparable period in 2005.

We expect general and administrative expenses to increase slightly in absolute dollars throughout the remainder of fiscal 2006.

Restructuring charge. SumTotal Systems negotiated what is expected to be a final lease termination agreement for its Chicago facility in which, for a lump sum payment of approximately $0.7 million, SumTotal Systems will effect a cancellation of the lease. The difference between the net remaining estimated lease liability and the termination settlement amount of $0.7 million resulted in an accrual of $0.01 million that has been accrued at September 30, 2006 as a restructuring charge in the third quarter of 2006.

Table of Contents

Comparison of Operating Expenses for the Nine-Months Ended September 30, 2006 and 2005

	Nine-Months Ended			
	September 30, 2006	September 30, 2005	Variance in Dollars	Variance in Percent
Research and development	$ 12,711	$ 8,897	$ 3,814	42.9%
Percentage of net sales	*16.6 %*	*17.4 %*		
Sales and marketing	22,760	17,800	4,960	27.9%
Percentage of net sales	*29.8 %*	*34.9 %*		
General and administrative	15,123	10,929	4,194	38.4%
Percentage of net sales	*19.8 %*	*21.4 %*		
Restructuring charge	68	—	68	—
Percentage of net sales	*0.1 %*			
Total	$ 50,662	$ 37,626	$ 13,036	34.6%
Percentage of net sales	*66.3 %*	*73.7 %*		

Research and development. Expenses relating to research and development personnel increased $2.1 million or 34%, to $8.2 million from $6.1 million in the comparable period in 2005, due to increased salary costs for additional personnel including those resulting from the acquisition of Pathlore, and increased staffing in India. Consulting expenses in the nine-months ended September 30, 2006 increased to $1.2 million from $0.4 million in the comparable period in 2005. Additional staff and consultants were needed to support work on our product platform specifically on our release SumTotal 7.2 in June 2006 and 7.5 which is scheduled for release later in 2006. Facility and equipment expenses in the nine-months ended September 30, 2006 increased to $2.4 million from $1.9 million in the comparable period in 2005. Miscellaneous expenses for recruiting and travel in the nine-months ended September 30, 2006 increased by $0.1 million. Stock-based compensation expense in the nine-months ended September 30, 2006 increased by $0.3 million from the comparable period in 2005 due to the adoption of SFAS No. 123(R).

Sales and marketing. Expenses relating to sales and marketing personnel in the nine-months ended September 30, 2006 increased $2.8 million or 23%, to $14.8 million from $12.0 million in the comparable period in 2005, due to increased salary costs from additional personnel including those as a result of the acquisition of Pathlore, and higher commissions and bonus costs. Marketing programs expenses in the nine-months ended September 30, 2006 increased $0.7 million from the comparable period in 2005. Travel expenses associated with increased staff in the nine-months ended September 30, 2006 increased by $0.6 million from the comparable period in 2005. Miscellaneous expenses related to facilities, recruiting and other outside services in the nine-months ended September 30, 2006 increased by $0.3 million from the comparable period in 2005. Stock-based compensation expense in the nine-months ended September 30, 2006 increased by $0.6 million from the comparable period in 2005 due to the adoption of SFAS No. 123(R).

General and administrative. For the nine-months ended September 30, 2006, accounting expenses and consulting fees associated with compliance with Sarbanes-Oxley Section 404 decreased $0.4 million or 22%, to $1.5 million from $1.9 million in the comparable period in 2005. Expenses relating to general and administrative personnel in the nine-months ended September 30, 2006 increased $3.6 million or 67%, to $9.0 million from $5.4 million in the comparable period in 2005. The increased costs were related to increased salaries and related expenses for additional staff to support the Pathlore acquisition of $1.7 million, increased staff to support growth in our internal infrastructure and performance related bonuses, the sum of which was $1.9 million. The remaining increase of $1.0 million was related to an increase in stock-based compensation expense of $0.9 million due to the adoption of SFAS No. 123(R), and increases in miscellaneous and other expenses of $0.01 million in 2006 from the comparable period in 2005.

Restructuring charge. SumTotal Systems negotiated what is expected to be a final lease termination agreement for its Chicago facility in which, for a lump sum payment of approximately $0.7 million SumTotal Systems will effect a cancellation of the lease. The difference between the net remaining estimated lease liability and the termination settlement amount of $0.7 million resulted in an accrual of $0.01 million that has been accrued at September 30, 2006 as a restructuring charge in the third quarter of 2006.

Non-Operating Expenses, Net

The following tables are a summary of interest expense, interest income and other expense, net (in thousands, except percentages):

Comparison of Non-Operating Expenses, Net for the Three-Months Ended September 30, 2006 and 2005

	Three-Months Ended			
	September 30, 2006	September 30, 2005	Variance in Dollars	Variance in Percent
Interest expense	$ (429)	$ (4)	$ (425)	10,625%
Percentage of net sales	*(1.6)%*	*0.0 %*		
Interest income	180	227	(47)	(20.7)%
Percentage of net sales	*0.7 %*	*1.2 %*		
Other income (expense), net	(49)	(121)	72	(59.5)%
Percentage of net sales	*(0.2)%*	*(0.7)%*		
Total	$ (298)	$ 102	$ (400)	(392.2)%
Percentage of net sales	*(1.1)%*	*0.6 %*		

Interest expense. The increase in interest expense is primarily due to the credit facility added to fund the Pathlore acquisition. We expect this expense to continue over the term of the credit facility. However, it will vary based on the changes in the principal balance.

Interest income. In the three-months ended September 30, 2006, interest income was $0.2 million and $0.2 million for 2006 and 2005, respectively.

Other income (expenses), net. Beginning in the third quarter of 2006, we have adopted a forward exchange hedging program for US Dollar and British Pound Sterling contracts which we believe will minimize future fluctuations related to changes in these exchange rates.

Comparison of Non-Operating Expenses, Net for the Nine-Months Ended September 30, 2006 and 2005

	Nine-Months Ended			
	September 30, 2006	September 30, 2005	Variance in Dollars	Variance in Percent
Interest expense	$ (1,295)	$ (5)	$ (1,290)	25,800%
Percentage of net sales	*(1.7)%*	*0.0 %*		
Interest income	532	582	(50)	(8.6)%
Percentage of net sales	*0.7 %*	*1.1 %*		
Other income (expense), net	131	(493)	624	(126.6)%
Percentage of net sales	*0.2 %*	*(1.0)%*		
Total	$ (632)	$ 84	$ (716)	(852.4)%
Percentage of net sales	*(0.8)%*	*0.2 %*		

Interest expense. The increase in interest expense is primarily due to the credit facilities added to fund the Pathlore acquisition. We expect this expense to continue over the term of the credit facility. However, it will vary based on the changes in the principal balance.

Interest income. We expect this income to continue at comparable amounts as we plan to continue to manage our cash and short-term investment balances in a similar fashion.

Other income (expenses), net. Beginning in the third quarter of 2006, we have adopted a forward exchange hedging program for US Dollar and British Pound Sterling contracts which we believe will minimize future fluctuations related to changes in these exchange rates.

Liquidity and Capital Resources

At September 30, 2006, our principal sources of liquidity were $13.4 million of cash and cash equivalents and $4.2 million of short-term investments. U*nder our revolving credit facility (“Revolver”) with Wells Fargo Foothill, Inc. (“Wells

Fargo”) in July 2006, SumTotal Systems entered into an agreement with Wells Fargo Bank in which SumTotal Systems will enter into forward foreign exchange contracts to mitigate certain foreign exchange exposures the Company has related to foreign trade receivables. As part of this agreement the credit facility provides for a 5% reserve against the Revolver. As a result of the 5% reserve requirement SumTotal will have $250,000 less in funds available for use including debt covenant compliance, under the Revolver.

We believe that our available cash resources, combined with cash flows generated from operations, will be sufficient to meet our presently anticipated working capital and capital expense requirements for at least the next 12 months. We will continue to monitor our cash and liquidity and will seek additional financing or make additional expense reductions if it becomes required.

On June 1, 2006, SumTotal Systems filed a universal shelf registration statement on Form S-3 with the Securities and Exchange Commission which was declared effective October 2, 2006. The registration statement will allow SumTotal the flexibility to issue securities, which may consist of common stock, preferred stock, warrants, debt securities or any combination thereof, in one or more future offerings up to a maximum aggregate offering price of $75 million. A prospectus supplement will describe the terms of any particular offering made under the universal shelf registration statement. Unless otherwise indicated in a prospectus supplement, the net proceeds from the sale of securities offered by SumTotal Systems under the prospectus may be used for general corporate purposes and working capital requirements. SumTotal Systems may also use all or a portion of the net proceeds to fund possible investments in, and acquisitions of, companies, businesses, partnerships, minority investments, products or technologies. Currently, there are no commitments or agreements regarding such acquisitions or investments. SumTotal Systems may also use a portion of the net proceeds to repay or prepay indebtedness under its credit facility with Wells Fargo which was entered into in connection with SumTotal Systems’ acquisition of Pathlore Software Corporation.

Our future liquidity and capital requirements will depend on numerous factors, including our future revenues, the timing and extent of spending to support product development efforts and expansion of sales and marketing and general and administrative activities, the success of our existing and new product and service offerings and competing technological and market developments. There can be no assurance that additional funding, if needed, will be available on terms acceptable to us, if at all.

Net cash provided by operating activities was $3.6 million in the nine-months ended September 30, 2006. The cash provided during the period was primarily due to net decreases in accounts receivable of $2.6 million and net increases in accounts payable of $0.8 million and accrued compensation and benefits of $1.0 million and net increases of intangible asset amortization of $6.6 million and stock based compensation of $3.1 million, partially offset by net decreases in deferred revenues of $1.7 million and reductions in our accrued restructuring liability balance of $1.7 million. The net decrease in accounts receivable was due to stronger collections and better receivable management. The increase in stock-based amortization expense is a result of the adoption of SFAS 123(R) effective January 1, 2006. The reduction in the accrued restructuring liability is a result of cash payments of the related restructuring liability.

Net cash used in investing activities was $6.7 million in the nine-months ended September 30, 2006, and was due to purchases of property and equipment related to our efforts to build our infrastructure to support our growing operations. These expenditures included approximately $1.3 million associated with fixed assets and leasehold improvements for SumTotal Systems new research and development facility in Hyderabad, India. In addition, the Company has been purchasing longer term interest-bearing investments carried in short-term investments which, as of September 30, 2006, had a carrying value of $4.2 million.

Net cash used in financing activities was $1.4 million in the nine-months ended September 30, 2006 due to repayments on the Wells Fargo credit facility of $3.3 million and a note payment of $0.5 million offset by $2.3 million in net proceeds from the issuance of common stock through our ESPP and exercises of common stock options.

Concurrent with the closing of the Pathlore Acquisition on October 4, 2005, we entered into a credit facility with Wells Fargo principally to fund a portion of the acquisition price, and to provide for its ongoing working capital requirements. For terms and details of the credit facility including the requirement that we maintain certain restrictive covenants, refer to Note 5 “ *Bank Credit Facility* ” in the unaudited Condensed Consolidated Financial Statements. For additional information regarding the terms and details of our significant payment commitments and contingencies, refer to Note 7 “Commitments and Contingencies” in the unaudited Condensed Consolidated Financial Statements.

We have entered into various arrangements with hosting services vendors and various non-cancelable operating facility lease agreements for our offices throughout the U.S. and for our international subsidiaries with original lease periods expiring through 2015. In addition, we are under contract to fulfill facility leases for offices that were subleased to third party companies under restructuring plans.

Recent Accounting Pronouncements

Refer to the discussion of recent accounting pronouncements in Note 2 " *Summary of Significant Accounting Policies* " in our unaudited Condensed Consolidated Financial Statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market Rate Risk. We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not use derivative financial instruments for speculative or trading purposes.

Interest Rate Risk. We hold our assets primarily in cash and cash equivalents, such as short-term marketable debt securities, money market funds and other cash equivalents and short-term investments such as commercial paper, publicly traded common stock and treasury notes. We minimize risk by investing in financial instruments with original maturities of less than one year. As a result, if market interest rates were to increase immediately and uniformly by 10% from levels at September 30, 2006, the fair value of cash and cash equivalents and short-term investments would not change by a material amount.

Concurrent with the closing of the Pathlore acquisition on October 4, 2005, we entered into a credit facility with Wells Fargo, principally to fund a portion of the acquisition price, and to provide for our ongoing working capital requirements. Under the terms of the facility, Wells Fargo loaned us $17.5 million to complete the acquisition of Pathlore and provided a revolving credit facility to a maximum of $5.0 million to meet the working capital requirements of the business. The amounts outstanding bear interest at Wells Fargo's base rate plus 2%, unless we elect to be charged at the LIBOR rate plus 3.5%. As of September 30, 2006, we have elected to be charged at the LIBOR rate, which was 5.37% on September 30, 2006, resulting in a total interest rate of 8.87%. If market interest rates were to increase immediately and uniform by 10% from current levels at September 30, 2006, our interest payments on the credit facility over the term of the loan would not change by a material amount.

Foreign Currency Exchange Risk. We have foreign currency risk as a result of foreign subsidiary activities. In the nine-months ended September 30, 2006 international revenue from our foreign subsidiaries accounted for approximately 20% of total revenue, from 25% in the comparable period in 2005. All foreign subsidiaries use the local currency as their functional currency.

Our exposure to foreign exchange rate fluctuations arises in part from inter-company accounts in which costs incurred in the U.S. are charged to the foreign subsidiaries. These inter-company accounts are typically denominated in the functional currency of the foreign subsidiary in order to centralize foreign exchange risk with the parent company in the U.S. We are also exposed to foreign exchange rate fluctuations as the financial results of foreign subsidiaries are translated in U.S. dollars in consolidation. As exchange rates vary, certain transaction gains and losses may vary from expectations and adversely impact overall expected profitability. In addition, during the third quarter 2006, we began entering into 30 day forward contracts for USD and British Pound Sterling ("GBP") to hedge anticipated cash flows from our UK subsidiary. As of September 30, 2006, for the third quarter, we have an aggregate of $94,000 of realized foreign exchange losses on settled forward contracts. As of September 30, 2006, we entered into a forward contract for USD and GBP for which a hypothetical 10% appreciation of the GBP to USD would result in a $413,000 gain and a hypothetical 10% depreciation of GBP to USD would result in a $480,000 loss.

The effect of foreign exchange rate fluctuations in the nine-months ended September 30, 2006 was not material. Due to the substantial volatility of currency exchange rates, among other factors, we cannot predict the effect of exchange rate fluctuations on our future operating results.

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 September 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 September 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 September 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 2005 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 offsetting 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 nine months 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 the 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.

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

- Completed the system upgrade of the Company's accounting software to a more current release and continued to hire additional qualified personnel to strengthen the accounting and finance organizations.
- 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.
- Integrated its UK subsidiary onto the Company's enterprise-wide accounting software, in addition to training its UK employees on the software. This integration was supervised and monitored by the Corporate Controller.

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 re-mediating these remaining material control weaknesses.

PART II—OTHER INFORMATION

Item 1. Legal Proceedings

From time-to-time, we are involved in legal proceedings or threats of legal proceedings arising in the ordinary course of business. We are not currently a party to any litigation or other legal proceeding that, in the opinion of management, is reasonably likely to have a material adverse effect on our business, operating results and financial condition.

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 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 ability to successfully control expenses, especially in our services organization; (9) the overall movement toward industry consolidation among both our competitors and our customers; (10) recognition of impairment of existing assets; and (11) 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 talent and learning management solutions, and the rapidly evolving nature of the talent 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 identifiable 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 $14.2 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 September 30, 2006, we had $20.7 million comprising $15.7 million in qualified cash accounts and $5.0 million in excess availability under the revolver and therefore no test of the covenants was required. As part of this agreement the credit facility provides for a 5% reserve against the Revolver. As a result of the 5% reserve requirement SumTotal will have $250,000 less in funds available for use including debt covenant compliance, under the Revolver. Prospectively, at this time, SumTotal Systems anticipates it will only enter into forward foreign exchange hedging contracts to mitigate foreign currency exposures and will not enter into forward foreign exchange contracts for trading or speculative purposes.

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 our assets to repay outstanding debt of approximately $14.2 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.

Our business may not generate the cash needed to finance our operations or growth, and for that and other reasons we may need additional financing in the future, which we may be unable to obtain, or if we do, whether under the universal shelf registration we filed or otherwise, it may result in dilution to our current stockholder base.

Our recent acquisition of Pathlore decreased our cash position. If our business does not generate the cash needed to finance our operations or growth, including potential business acquisitions or investments, we may need to obtain additional financing or take steps to restrict our operations in order to conserve existing cash. In addition, poor financial results or unanticipated expenses could give rise to additional financing requirements. Therefore, we have filed a universal shelf registration statement on Form S-3 for an aggregate maximum offering of $75 million. We may be unable to obtain financing on terms favorable to us, or at all. If we are able to raise additional funds, if necessary, the issuance of additional shares may result in investor dilution. Further, it may be more difficult to obtain additional financing because of our credit facility, whether under the Form S-3 or otherwise. If we need to obtain financing and adequate funds are not available or are not available on acceptable terms, we may be required to make further expense reductions, which could significantly restrict our operations and limit our ability to enhance our products, fund expansion, respond to competitive pressures or take advantage of business opportunities, thereby resulting in a decrease in our revenues and stock price.

If we fail to mitigate our risk in foreign exchange fluctuations with the hedging contracts that we enter into, our statement of operations may be negatively impacted, which could in turn result in loss of investor confidence.

Given the international nature of our business, we have assets and liabilities denominated in foreign currencies, and are therefore subject to losses due to fluctuations in foreign exchange rates. We have entered into, and will likely in the future enter into, forward foreign exchange hedging contracts in an attempt to mitigate such foreign exchange currency risk. If we fail to estimate such exposures accurately, then this could negatively affect our statement of operations, may cause a loss in investor confidence, and therefore a decrease in our stock price.

Our products contain defects, and, if we cannot fix any material defects in a timely fashion, we may need to halt further sales or shipments of our products, delay introduction of new products, and/or account for warranty claims.

Our product offerings, both current and future, are complex and often contain defects, including software and process errors, incorrect code, faulty error handling, incomplete use cases, known and unknown, despite internal and third party testing. New product offerings contain new features and functionality, which result in a greater likelihood of defects, and frequently, defects are undetected until the period immediately following introduction and initial shipment of new products or enhancements to existing products. For example, although we attempted to discover and resolve all defects in our new product line that we believed would be considered serious by our customers before shipment to them, SumTotal 7.x Series is not error-free and some customers have notified us that they consider some of the defects in the SumTotal 7.x Series to be serious.

In addition, our products include third party software, and any defects in third party software that we incorporate in our products will compromise our products. It may be difficult for us to correct any errors in third party software because the software is not within our control. Accordingly, our revenue could decrease and our costs could increase in the event of any errors in this technology. Furthermore, we may become subject to legal claims related to defects in our products, including defects in licensed technology, based on product liability, infringement of intellectual property or other legal theories. The defects, some of which were unknown to us, some which may yet to be discovered, and others of which may manifest themselves in future releases of our products, could cause performance problems and result in material adverse financial consequences to our customers and us, including without limitation, delay in recognizing, declining or lost revenues and delay in customer acceptance.

If we fail to successfully manage our product transition to, or fail to successfully deploy upgrades to our SumTotal 7.x Series on a timely basis, our business and financial results will be harmed.

We introduced SumTotal 7.0 in December 2004, SumTotal 7.1 in April 2005, SumTotal 7.2 in April 2006, and plan to launch subsequent product releases over the next year. We face numerous risks relating to product transitions, including customers delaying their purchasing decision until they have confidence in our new product and until we have proven we can successfully install and implement SumTotal 7.x Series. Due to the product transition, we may be unable to accurately forecast revenue from product sales and related services, the number and severity of defects and increased support requirements due to the complexity of the new product. In order to successfully market and sell the product, we must ensure broad-based cooperation from and coordination between multiple departments, including engineering and marketing, and from multiple geographic regions, including Bellevue, Washington, Mountain View, California, and Hyderabad, India. If we fail to successfully manage the transition to this new product offering, our business and financial results may be adversely affected, which may cause a decline in the price of our common stock.

Our lack of product diversification, and our reliance on the SumTotal Systems Suite, means that any decline in price or demand for our products and services would seriously harm our business.

We expect SumTotal Systems Suite and, in particular, our new product, SumTotal 7.x Series and successor products and related services to continue to account for a significant majority of our revenue for the foreseeable future. Consequently, a decline in the price of, or demand for, the SumTotal Systems Suite and successor products or services, or their failure to achieve broad market acceptance, would seriously harm our business and would likely result in the decline of our common stock.

Our intellectual property is subject to, and may be subject to, legal challenges or unauthorized use or claims of infringement, any of which could diminish the value of our products and services or deter customers from purchasing our products.

Our success depends in large part on our proprietary technology. We rely on a combination of copyrights, trade secret and trademark laws, contractual restrictions, restrictions on disclosure and other methods to protect our proprietary technology. These legal protections afford only limited protection for our technology. We do not rely on patents to protect our intellectual property either in the United States or in foreign jurisdictions. Furthermore, effective protection of intellectual property rights is unavailable or limited in certain foreign countries. It may also be possible for third parties to copy or otherwise obtain and use our intellectual property or trade secrets without our authorization and it may be possible for third parties to independently develop substantially equivalent intellectual property. We cannot assure you that the protection of our proprietary rights will be adequate or that our competitors will not independently develop similar technology, duplicate our products and services or design around any patents or other intellectual property rights we hold. Consequently the value of our products and services to our customers could diminish substantially.

From time-to-time, we are involved in legal proceedings or threats of legal proceedings. Litigation is expensive to defend and even the threat of legal proceedings diverts management attention from operating our business and causes increases in our expense levels. In addition, from time-to-time, we have received, and may in the future receive, threatening letters and notice of claims of infringement of other parties' proprietary rights. Such claims could result in costly litigation and could divert management and technical resources. They could also delay product shipment or require us to develop non-infringing technology or enter into royalty or licensing agreements, which agreements may not be available on reasonable terms, or at all. In the event of an adverse judgment against us (including a judgment or settlement which may impose adverse conditions on us), we may be required to cease shipping, to pay damages, to license technology on terms that may not be favorable to us or to alter our technology, website or software products, any of which may adversely affect our operating results and cause us to meet our forecasts or industry analysts' forecasts, thereby causing a possible decline in the price of our common stock.

Our products include third party technology, the loss of which could materially harm our business.

We use some licensed third party technology components in our products. Future licenses to this technology may not be available to us on commercially reasonable terms, or at all. The loss of or inability to obtain or maintain any of these technology licenses could result in delays in the introduction of new products or could force us to discontinue offering portions of our talent and learning management solutions until equivalent technology, if available, is identified, licensed and integrated.

Security and privacy breaches could subject us to litigation and liability.

We host certain of our customers' talent and learning management software implementations and provide access to that software using the Internet. Computer viruses could be introduced into our systems or those of our customers, which could disrupt the operation of our hosting systems or make them inaccessible to users and we depend on third parties to provide key components of our networks and systems and Internet service providers and telecommunications companies and the efficient operation of their computer networks and other computer equipment to enable customers to access and use hosted software implementations.

We could become subject to litigation and liability if third parties penetrate security for our hosting systems or otherwise misappropriate our users' confidential information, or if customers are unable to access and use hosted software implementations. Advances in computer capabilities, new discoveries in the field of cryptography or other technological events or developments could result in compromises or breaches of our security systems. Anyone who circumvents our security measures could misappropriate proprietary information or cause interruptions in our services or operations. We may be required to expend significant capital and other resources to protect against the threat of security breaches or service interruptions or to alleviate problems caused by breaches or service interruptions. Each of our key third party networks and systems component providers, Internet service providers and telecommunications companies partners has experienced significant outages in the past and could experience outages, delays and other difficulties due to system failures unrelated to our systems, which could cause our customers to believe we were at fault and withhold payments due to us, decreased revenue and a decline in the price of our stock.

Our disaster recovery plan does not include redundant back-up computer systems, and a disaster could severely damage our operations.

Our disaster recovery plan does not include redundant back-up computer systems at an alternate site. A disaster could severely harm our business because our computer systems could be interrupted for an indeterminate length of time. Our operations depend on our ability to maintain and protect the computer systems needed for our day-to-day operations. A number of these computer systems are located in Mountain View, California on or near known earthquake fault zones and flood plains. Although these systems are designed to be fault tolerant, they are vulnerable to damage from fire, floods, earthquakes, power loss, telecommunications failures and other events. Any damage to our facility could lead to interruptions in the services we provide to our customers and loss of customer information, and could impair our ability to operate our business, leading customers to withhold payments due to us and decreased revenue. The business interruption insurance we maintain may not be adequate to cover our losses resulting from disasters or other business interruptions, which would result in increased expenses and a possible decline in our stock price as well.

Terrorism and U.S. military actions may adversely affect our business.

In light of recent terrorist activity, political and military instability, and existing and possible U.S. military actions, significant instability and uncertainty in the world may continue to have a material adverse effect on world financial markets, including financial markets in the U.S. In addition, such adverse political effects may have an adverse impact on economic conditions in the U.S. Unfavorable economic conditions in the U.S. may have an adverse effect on our business operations including, but not limited to, our ability to expand the market for our products, obtain financing as needed, enter into strategic relationships and effectively compete in the talent and learning management markets. Such consequences may lead to a decrease in demand for our products and services and as a result our stock price may suffer.

We may not be able to adapt to rapidly changing technology and evolving industry standards and if, as a result, our products become obsolete or there is a delay in meeting our customer needs, we would lose market share.

The talent and learning management software market is characterized by rapidly changing technologies, frequent new product and service introductions, short development cycles and evolving industry standards. The introduction of new products and services embodying new technologies and the emergence of new industry standards may render our products and services obsolete. Our success depends on our ability to adapt to a rapidly changing landscape and to offer new products and services to address our customers' changing demands. We may experience difficulties that delay or prevent the successful design, development, introduction or marketing of our products and services. To the extent we in fact experience such delays, we may experience difficulty in attracting new customers and may lose existing customers.

Market acceptance of new platforms and operating environments may require us to undergo the expense of developing and maintaining compatible product lines.

Although our software products can be licensed for use with a variety of popular industry standard relational database management system platforms, specific operating systems, or other combinations of licensed software, there may be currently existing or future platforms or user interfaces that achieve popularity in the marketplace which may not be architecturally compatible with our software product design. Developing and maintaining consistent software product performance characteristics across all of these combinations could place a significant strain on our resources and software product release schedules, which could adversely affect revenue and results of operations. To maintain software performance across accepted platforms and operating environments, to achieve market acceptance of those that we support, or to adapt to popular new ones, our expenses may increase and our sales and revenues may be adversely affected.

The business performance and learning management software market is highly competitive, and we may be unable to compete successfully.

The market for our products and services is intensely competitive, dynamic and subject to rapid technology change. While we believe there is a trend toward market consolidation, the business performance and learning management software market is still highly fragmented and competitive, with no single company accounting for a dominant share of the market.

Our competitors vary in size, scope and the breadth of products and services offered. We face competition from: (1) other developers of business performance and learning technology systems; (2) providers of other business performance and learning technology solutions; (3) vendors of other enterprise software applications that are beginning to offer learning delivery and management functionality; (4) large professional consulting firms and in-house information technology departments; and (5) developers of web authoring tools. Additionally, companies may choose to develop their own business performance and learning management software internally rather than acquiring it from third parties.

There are relatively low barriers to entry in the business performance and learning technology market, and we expect the intensity of competition to increase in the future. Increased competition may result in price reductions, reduced gross margins or loss of market share, any of which could seriously harm our business and financial results.

In addition, some of our existing and potential competitors have longer operating histories and significantly greater financial, technical, marketing and other resources and therefore may be able to respond more quickly to new or changing opportunities, technologies, standards and customer requirements to compete more aggressively on pricing, or to sustain prolonged periods of negative cash flows and unfavorable market conditions. We may not be able to compete successfully against our current and future competitors, and competitive pressures that we encounter may seriously harm our business.

We are facing significant resource constraints in our professional services group.

We expect revenue from our professional services group to continue to grow in terms of absolute dollars and as a percentage of our total revenue. For instance, in fiscal 2005, professional services consulting revenue was approximately 24% of our overall revenue. At times, the demand for our professional services exceeds our available resources. Even if we are successful in recruiting additional professional services personnel, which we may not be, it will take time for the new personnel to become familiar with our products and to integrate into our company. As such, we may not be able to meet customer demands, thereby causing potential delays in, or adverse decisions in, purchasing decisions or upgrade challenges, causing customer dissatisfaction and potential warranty or breach of contract claims, which may harm our operating results and result in a decline in the price of our common stock.

The business performance and learning management software market may not grow to a sufficient size or at a sufficient rate to sustain our business.

Corporate training and education historically have been conducted primarily through classroom instruction. Although technology-based training applications have been available for many years, they currently account for only a small portion of the overall corporate learning market. Accordingly, our success will depend on the extent to which companies implement business performance and learning management software solutions for the design, development, delivery and management of their corporate learning needs.

Many companies that have already invested substantial resources in traditional training methods may be reluctant to adopt a new strategy that may limit or compete with their existing investments. Even if companies implement business performance and learning management software solutions, they may still choose to develop such solutions internally. If the use of business performance and learning management software does not become widespread, or if companies choose to develop such software internally rather than acquiring it from third parties, then our business performance and learning management software may not be commercially successful.

Our stock price has been and may continue to be volatile.

The trading price of our common stock has been and is likely to continue to be highly volatile. Our stock price is subject to continued fluctuations in response to a number of factors, including: (1) actual or anticipated variations in quarterly operating results; (2) changes in financial estimates or recommendations by securities analysts; (3) compliance with Sarbanes-Oxley and, in particular, Sarbanes-Oxley Section 404, including the cost of identifying and remedying significant deficiencies and material weaknesses in our internal controls; (4) conditions or trends in business performance and learning management markets; (5) announcements by us or our competitors of significant customer wins, technological innovations, new products or services, significant acquisitions, strategic partnerships, joint ventures or capital commitments; (6) failure to accurately forecast our sales, especially since we rely on the sales of a small number of relatively large orders; (7) the seasonal fluctuations of our customers' buying decisions; (8) additions or departures of key personnel, including the recent departure of our President, and; (9) general market conditions.

Fluctuations in the price and trading volume of our common stock may prevent stockholders from reselling their shares above the price at which they purchased their shares.

In addition, companies that have experienced volatility in the market price of their stock have been subject to securities class action litigation, and we may be the target of this type of litigation in the future. Securities litigation, like other litigation against us could result in substantial costs, negative publicity and divert our management's attention, which could seriously harm our business and stock price.

Our recent stock performance may impair the carrying value of our goodwill and intangible assets.

Our common stock has declined from $8.00 per share on the first trading day following March 18, 2004 when the acquisition of Docent was completed, to $6.35 per share at the close of market on October 31, 2006. The carrying value of our goodwill and intangible assets on September 30, 2006 was $62.3 million and $19.1 million, respectively. A further sustained decline in our stock price could help trigger an impairment analysis, which then might result in an impairment based not only on stock price but other factors.

We have experienced and may continue to experience turnover of senior management and key personnel, which could harm our business or operations and competition for other personnel is competitive and getting more competitive.

Our success depends to a significant degree on the performance of the senior management team and other key employees. While our Section 16 officers were granted two-year retention agreements in October 2005, around the time our former chief executive officer resigned, there is no guarantee that such officers, as well as other employees, will remain employed with us. The loss of any of these individuals could harm our business. We do not have employment agreements other than offer letters with our executives or with any other key employee, and we do not maintain key person life insurance for any officer or key employee.

Our success also depends on our ability to attract, integrate, motivate and retain highly skilled technical, sales and marketing and professional services personnel. Competition for qualified personnel in the software industry, particularly engineering and other technical personnel, is intense and is increasing, and there can be no assurance that we will be able to attract and retain highly skilled employees in sufficient numbers to sustain our current business or to support future growth.

A substantial amount of our engineering activities are based in Hyderabad, India and are subject to contingencies and delays that aren't typically experienced with stateside engineering efforts.

We rely significantly on our engineering operations in Hyderabad, India to enable us to complete customer implementation projects and new releases of our products on time and within established budgets.

Our efforts in Hyderabad and elsewhere abroad are subject to a number of risks inherent in international operations, including: (1) difficulties and costs of recruiting and retaining qualified engineers and other personnel in our foreign offices; (2) different learning styles and cultures; (3) intense and increasing competition from other technology companies with regard to hiring and retaining qualified personnel; (4) increasing growth and development of the technology market in India generally, and in Hyderabad specifically, increasing competition and costs of hiring and retaining qualified personnel and acquiring additional space to sustain and support future growth there; (5) numerous and potentially conflicting regulatory requirements; (6) export controls; (7) import tariffs and other barriers to trade, changes in laws or governmental policies; (8) reduced protection of intellectual property rights; (9) regional political and economic instability; (10) challenges with reliability in our infrastructure, given that India does not have the same scale and reliability of overall infrastructure relative to stateside; and (11) fluctuations in currency exchange rates which could adversely impact our reported other income and expense.

If our India or other overseas operations fail, for any reason, to provide adequate and timely product enhancements, updates and fixes to us or customer implementations, our ability to fix defects in our SumTotal 7.x Series, our ability to develop new versions of our SumTotal 7.x Series, and our ability to respond to customer or competitive demands would be harmed and we would lose sales opportunities and customers.

In addition, our engineering efforts are based primarily out of two offices: Bellevue, Washington and Hyderabad, India. If the two offices fail to work together successfully, we may experience delays in fixing defects in SumTotal 7.x Series, customer implementations, or in developing and releasing future versions of our product.

We rely on independent partners and third parties to help conduct our international operations and provide engineering services, including product development and customer implementation and sales and marketing efforts.

We rely on independent partners such as distributors, alliance partners, value-added resellers, and system integrators to help conduct our international operations and sales and marketing efforts in many foreign countries. We also use independent third parties to provide engineering services. Moreover, we expect to increasingly rely on these independent partners for the product development, customer implementation, distribution and sale of our branded products globally. Our success in international markets consequently will depend to a large degree on the success of these independent partners, with whom we have a limited working experience and over whom we have little control. If they are unwilling or unable to dedicate sufficient

resources to our relationships, our international operations will suffer so our future success will depend in part on our ability to attract, train and motivate new distributors, resellers, alliance partners and systems integrators and expand our relationships with current independent partners. We may not be successful in expanding our distributor and reseller relationships, and our sales would suffer as a result. Further, we will be required to invest significant additional resources in order to expand these relationships, and the cost of this investment may exceed the revenues generated from this investment.

The operations of these partners are based outside the U.S. and are therefore subject to risks distinct from those that face U.S.-based operations, including: (1) the burden of complying with a variety of foreign laws; (2) language barriers; (3) longer payment cycles and greater difficulty in collecting accounts receivable; (4) reduced protection of intellectual property rights; (5) fluctuating exchange rates; (6) price controls and other restrictions on foreign currency; (7) military action or political upheaval in the host countries which could force these partners to terminate the services they are providing to us or to close their operations entirely; and (8) social unrest or disturbances.

Our internal control over financial reporting and disclosure controls and procedures are not effective and may not be adequate to prevent or detect misstatements or errors, which could cause us to have to restate our financial statements and cause our stock price to decline or subject us to costly litigation.

As of December 31, 2004 and 2005, management has concluded that our internal controls over financial reporting and disclosure controls have been ineffective due to material weaknesses in our internal control over financial reporting. While we continue to take steps to remediate material weaknesses and test the adequacy of our initiatives to remediate these material weaknesses, we cannot assure you that our efforts will be successful or that additional material weaknesses will not be found. If we are not successful in remediating these material weaknesses or if other material weaknesses are found, we cannot assure you that our financial statements will be error free. If errors are found in the financial statements that we file with the Securities and Exchange Commission, we may be required to restate those financial statements which could result in a loss of investor confidence in us, cause our stock price to decline and subject us to costly litigation.

A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Our management does not expect that our internal controls and procedures will prevent all errors and all fraud because, in addition to resource constraints, there are inherent limitations of all control systems, including the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls and procedures can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of a control or procedure. The design of any system of controls and procedures is also based in part on 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. Because of the inherent limitations in a control system, misstatements due to error or fraud may occur and not be detected. In such event, we may not, for instance, be able to recognize revenue we expected to recognize; we may not be able to meet our forecasts or industry analysts' projections; or we may be the subject of litigation, each of which would likely harm our financial results and may result in a decline in the price of our common stock.

Standards for compliance with Section 404 of the Sarbanes-Oxley Act of 2002 are burdensome and uncertain, and if we fail to comply in a timely manner, our business could be harmed and our stock price could decline.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, our management is required to report on, and our independent registered public accounting firm to attest to, the effectiveness of our internal controls over financial reporting, at least annually. The rules governing the standards that must be met for management to assess our internal controls over financial reporting are new, complex and subject to proposed changes. Currently, the rules require significant documentation, testing and possible remediation of our internal controls over financial reporting. The process of reviewing, documenting and testing our internal controls over financial reporting will likely continue to result in increased expenses and the devotion of significant management and other internal resources. As we did in connection with our report on internal controls in 2004, we may encounter problems or delays in completing the implementation of any changes necessary to make a favorable assessment of our internal controls over financial reporting during fiscal 2006. During this process, if we are unable to effectively remediate our material weaknesses, or if our management identifies one or more material weaknesses in our internal control over financial reporting, we will be unable to assert such internal control is effective, and the price of our stock may suffer.

We were not able to comply with the requirements of Section 404 for fiscal 2004 on a timely basis and had to delay filing our Annual Report on Form 10-K until August 1, 2005. We had numerous material weaknesses, and developed and implemented extensive remediation plans. Although we have reduced the number of material weaknesses in 2005 compared to 2004, we still have some material weaknesses, and there is no assurance that our remediation plans will effectively address

the material weaknesses, or that such changes in our control procedures will not create other material weaknesses. If our management is unable to assert that our internal control over financial reporting is effective (or if our independent registered public accounting firm is unable to attest that our management report is fairly stated or they are unable to express an opinion on the effectiveness of our internal controls) we may not be able to timely file, or file at all, our periodic financial reports, and thus we will be subject to delisting. Even if we are able to file such reports, investor confidence in the accuracy and completeness of our financial reports may be lost, leading to an adverse effect on the price of our stock.

If we are unable to effectively remediate any additional material weaknesses identified by us or our independent registered public accounting firm, we will be unable to assert such internal control is effective. If internal controls and procedures are determined to be inadequate and ineffective, this may result in a loss of shareholder confidence and adversely impact our stock price.

Recently enacted and proposed changes in securities laws and regulations have increased and are likely to continue to increase our expenses.

Recently enacted and proposed changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002, have increased, and will continue to increase our expenses as we devote resources to respond to the new requirements. The Sarbanes-Oxley Act mandates, among other things, that companies adopt new corporate governance measures, and it imposes comprehensive reporting and disclosure requirements; sets stricter independence and financial expertise standards for audit committee members; and imposes increased civil and criminal penalties for companies, their chief executive officers, chief financial officers and directors for securities law violations. In addition, the NASDAQ Global Market, on which our common stock is listed, has also adopted comprehensive rules and regulations relating to corporate governance. These laws, rules and regulations have increased and will continue to increase the scope, complexity and cost of our corporate governance, reporting and disclosure practices, which could harm our results of operations and divert management’s attention from business operations. While we are endeavoring to reduce the costs of compliance, compliance is costly due to the necessity of hiring additional personnel and external consultants and our independent registered public accounting firm. For example, we incurred over $4.0 million dollars in fiscal 2005 on compliance costs related to the Sarbanes-Oxley Act which directly increased our general and administrative operating expenses and contributed to our loss from operations in fiscal 2005. We also expect these developments to make it more difficult and more expensive for us to obtain director and officer liability insurance in the future, and we may be required to accept reduced coverage or incur substantially higher costs to maintain coverage. Further, our directors and executive officers could face an increased risk of personal liability in connection with the performance of their duties. As a result, we may have difficultly attracting and retaining qualified directors and executive officers, which could adversely affect our business.

Changes in accounting regulations and related interpretations and policies, particularly those related to revenue recognition and share based payments, could cause us to defer recognition of revenue or recognize lower revenue or to report lower earnings per share.

While we believe that we are in compliance with SOP No. 97-2, *Software Revenue Recognition* , as amended, the AICPA continues to issue implementation guidelines for these standards and the accounting profession continues to discuss a wide range of potential interpretations. Additional implementation guidelines, and changes in interpretations of such guidelines, could lead to unanticipated changes in our current revenue accounting practices that could cause us to defer the recognition of revenue to future periods or to recognize lower revenue.

The FASB issued SFAS No. 123(R), *Share-Based Payment* , which requires us to recognize as an expense stock-based compensation to employees based on their fair values, and eliminates the ability to account for stock-based compensation using the intrinsic value method in accordance with APB No. 25, *Accounting for Stock Issued to Employees* . As a result, we began recording an expense for our stock-based compensation plans using the fair value method beginning in fiscal 2006, and we have had or may continue to have significant compensation charges. For example, in the first nine months of 2006, we recorded total stock-based compensation under SFAS No. 123(R) of $3.1 million.

We may become subject to government regulation and legal uncertainties that could result in liability or increase the cost of doing business, thereby adversely affecting our financial results.

We are not currently subject to direct regulation by any domestic or foreign governmental agency, other than regulations applicable to businesses generally, such as export control laws. However, due to the increasing popularity and use of the Internet, it is possible that a number of laws and regulations may become applicable to us or may be adopted in the future with respect to the Internet covering issues such as taxation, user privacy, content, right to access personal data, copyrights, distribution and characteristics and quality of services.

The applicability of existing laws governing issues such as taxation, property ownership, copyrights, and other intellectual property issues, encryption, libel, export or import matters and personal privacy to the Internet is uncertain. The vast majority of these laws were adopted prior to the broad commercial use of the Internet and related technologies. As a result, they do not contemplate or address the unique issues of the Internet and related technologies. Changes to these laws, including some recently proposed changes, could create uncertainty in the Internet marketplace. Such uncertainty could reduce demand for our services or increase the cost of doing business due to increased costs of litigation or increased service delivery costs.

In addition, we could be liable for the misuse of personal information. The Federal Trade Commission, the European Union and certain state and local authorities have been investigating certain Internet companies regarding their use of personal information. We could incur additional expenses if new regulations regarding the use of personal information are introduced or if these authorities choose to investigate our privacy practices.

Anti-takeover provisions could make the sale of the company more difficult.

Our certificate of incorporation and bylaws contain provisions that could make it harder for a third party to acquire us without the consent of our board of directors. For example, no potential acquirer would be able to call a special meeting of stockholders to remove our board of directors. A potential acquirer would also not be able to act by written consent without a meeting. In addition, our board of directors has staggered terms that make it difficult to remove all directors at once. The acquirer would also be required to provide advance notice of its proposal to remove directors at an annual meeting. The acquirer would not be able to cumulate votes at a meeting, which would require the acquirer to hold more shares to gain representation on our board of directors than if cumulative voting were permitted.

Subject to its fiduciary duties, our board of directors may in the future adopt a stockholder rights plan. If the board adopts a stockholder rights plan, it may discourage a merger or tender offer involving our securities that is not approved by our board of directors by increasing the cost of effecting any such transaction and, accordingly, could have an adverse impact on stockholders who may want to vote in favor of such merger or participate in such tender offer.

In addition, Section 203 of the Delaware General Corporation Law limits business combination transactions with 15% stockholders that have not been approved by the issuer’s board of directors. These provisions and other similar provisions make it more difficult or impossible for a third party to acquire us without negotiation. These provisions may apply even if the offer may be considered beneficial by some stockholders.

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

Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Submission of Matters to a Vote of Securities Holders

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

(a)	Exhibits
2.1	Amended and Restated Agreement and Plan of Merger by and among SumTotal Systems, Inc., Pathlore Software Corporation, Galaxy Acquisition Corporation, James Collis, as Stockholder Representative, and U.S. Bank National Association, as Escrow Agent dated September 19, 2005 (incorporated by reference to Form 8-K filed on September 23, 2005)
3.1	Amended and Restated Articles of Incorporation, filed with the Secretary of State of Delaware on March 18, 2004 (incorporated by reference to Form 8-K filed on March 19, 2004)
3.2	Amended and Restated Bylaws (incorporated by reference to Form 8-K filed on March 19, 2004)
4.1	Registration Rights Agreement dated as of November 15, 2001 by and between Click2learn and various investors (incorporated by reference to Click2learn’s Current Report on Form 8-K dated November 15, 2001)

4.2	Form of Warrant to Purchase Common Stock dated as of November 20, 2001 from Click2learn to various investors (incorporated by reference to Click2learn's Current Report on Form 8-K dated November 15, 2001)
4.3	Registration Rights Agreement dated as of June 20, 2003 by and between Click2learn and various investors (incorporated by reference to Click2learn's Current Report on Form 8-K dated June 20, 2003)
4.4	Form of Warrant to Purchase Common Stock dated as June 20, 2003 from Click2learn to various investors (incorporated by reference to Click2learn's Current Report on Form 8-K dated June 20, 2003)
4.5	Registration Rights Agreement between SumTotal, Inc. and certain stockholders of Pathlore Software Corporation dated August 3, 2005 (incorporated by reference to Exhibit 4.5 to Form 10-K filed March 28, 2006)
10.18	* Amended and Restated Change of Control Agreement, approved and adopted on August 16, 2006 (incorporated by reference to Form 8-K filed on August 17, 2006).
31.1	Certifications of Chief Executive Officer Pursuant to Securities Exchange Act Rules 13a- 14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certifications of Chief Financial Officer Pursuant to Securities Exchange Act Rules 13a- 14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Each exhibit marked with a (*) is a compensatory contract, plan or other arrangement in which one or more directors and/or executive officers are eligible to participate.

Table of Contents

SIGNATURES

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

SUMTOTAL SYSTEMS, INC.

November 8, 2006	/s/ NEIL J. LAIRD
Date	Neil J. Laird Executive Vice President and Chief Financial Officer (Duly Authorized Officer and Chief Financial and Chief Accounting Officer)

Table of Contents

Exhibit Index

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Exhibit 31.1

CERTIFICATIONS OF CHIEF EXECUTIVE OFFICER PURSUANT TO SECURITIES EXCHANGE ACT RULES 13a-14(a) AND 15d-14(a), AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Donald E. Fowler, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of SumTotal Systems, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in the Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2006

/s/ DONALD E. FOWLER
Donald E. Fowler
Chief Executive Officer and Director

Exhibit 31.2

**CERTIFICATIONS OF CHIEF FINANCIAL OFFICER
PURSUANT TO SECURITIES EXCHANGE ACT RULES 13a-14(a) AND 15d-14(a),
AS ADOPTED PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002**

I, Neil J. Laird, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of SumTotal Systems, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in the Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2006

/s/ NEIL J. LAIRD

Neil J. Laird
Executive Vice President and Chief
Financial Officer

Exhibit 32.1

**CERTIFICATIONS OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 906
OF THE SARBANES-OXLEY ACT OF 2002**

I, Donald E. Fowler, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of SumTotal Systems, Inc. on Form 10-Q for the fiscal quarter ended September 30, 2006 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of SumTotal Systems, Inc.

/s/ DONALD E. FOWLER
Donald E. Fowler
Chief Executive Officer and Director
Date: November 8, 2006

I, Neil J. Laird, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of SumTotal Systems, Inc. on Form 10-Q for the fiscal quarter ended September 30, 2006 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of SumTotal Systems, Inc.

/s/ NEIL J. LAIRD
Neil J. Laird
Executive Vice President and Chief
Financial Officer
Date: November 8, 2006