

SUMTOTAL SYSTEMS INC

FORM 10-K (Annual Report)

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

OR

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

Commission File Number: 000-50640

SUMTOTAL SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

42-1607228
(I.R.S. Employer Identification No.)

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

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

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

Table with 2 columns: Title of each class, Name of each exchange on which registered. Row 1: Common Stock, par value \$0.001; The Nasdaq Stock Market LLC

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the securities Act. [] Yes [X] No

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

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. [X] Yes [] No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [] Yes [X] No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. Refer to definition of “accelerated filer and large 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 Act). Yes No

The number of shares outstanding of the registrant’s common stock, par value \$0.001, as of March 1, 2007 was approximately 27,134,022 shares.

The aggregate market value of the common stock held by non-affiliates of the registrant, based upon the closing price of the common stock on June 30, 2006, on the (“Nasdaq”) Stock Market LLC of \$6.27 per share, was approximately \$157.1 million. For the purpose of the foregoing computation, only the directors and executive officers of the registrant were deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

Document incorporated by reference

As noted herein, the information called for by Part III of this Annual Report on Form 10-K is incorporated by reference to specified portions of the registrant’s definitive Proxy Statement to be filed in conjunction with the registrant’s 2007 Annual Meeting of Stockholders, scheduled to be held on June 8, 2007, which is expected to be filed not later than 120 days after the registrant’s fiscal year ended December 31, 2006 (the “2007 Proxy Statement”). Only those portions of the 2007 Proxy Statement which specifically address the items required to be set forth herein are incorporated by reference.

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FORM 10-K
For the Year Ended December 31, 2006

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This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. All statements other than statements of historical fact we make in this Annual Report are forward-looking. Such forward-looking statements, including, but not limited to, the words “may”, “plans”, “expects”, “anticipates”, “intends”, “targets”, “goals”, “seeks”, “believes”, “potential”, “continue” and similar language, and variations of such words, apply to, but are not limited to, statements regarding the following: our belief that our available cash resources, combined with cash flows generated from operations, will be sufficient to meet our presently anticipated working capital, capital expense and business expansion requirements for at least the next year; our belief that any current disputes will not result in litigation, but if they do, they will not have a material adverse effect on our business, operating results and/or financial condition; statements about future business operations; marketing statements; industry leadership; internal controls and procedures; statements about our product, SumTotal 7 Series; revenue recognition; financial performance including, but not limited to, estimated revenue, backlog, bookings, operating expense, gross margin and profit and market conditions that include risks and uncertainties are based on information that is available to us at the date of this Annual Report on Form 10-K 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 “Item 1A Risk Factors.” You are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date of this Annual Report on Form 10-K. We undertake no obligation to update any revisions to any forward-looking statement or reflect events or circumstances after the date of this document.

PART I

ITEM 1. BUSINESS

We maintain our executive offices and principal facilities at 1808 North Shoreline Boulevard, Mountain View, California 94043. Our telephone number is (650) 934-9500. We maintain a website at www.sumtotalsystems.com. Investors can obtain copies of our Securities and Exchange Commission (“SEC”) filings from our web site free of charge, as soon as reasonably practicable following such reports being filed or furnished with the SEC. Investors may also obtain such reports free of charge from the SEC website at www.sec.gov. In addition, our charter documents, as well as the Code of Ethics for our Chief Executive Officer, Senior Financial Officers, Other Senior Executive Officers and the Board of Directors and Reporting Hotline Policy for the Anonymous Reporting, Receipt, Treatment and Retention of Concerns to our SumTotal Systems, Inc. Board of Directors’ Audit Committee Members or Executive Staff are posted on our website. We intend to post any amendments or waivers to our Code of Ethics on our website.

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Background

We were originally incorporated as Asymetrix Corporation in the State of Washington in 1984, and since our incorporation have developed, marketed and sold a wide range of software products. In 1995, we focused our business on the enterprise learning market and created our first learning management system (“LMS”) in 1997. As a result of our decision to focus on the enterprise learning market, we divested several product lines and made a number of acquisitions to strengthen our position in this market. We also changed our name to Asymetrix Learning Systems, Inc. In connection with our initial public offering in June 1998, we reincorporated as a Delaware corporation and in 2001 we changed our name to Click2learn, Inc. (“Click2learn”).

On March 18, 2004, we merged with Docent, Inc., a public company listed on Nasdaq (“Docent”), to form SumTotal Systems, Inc. (“SumTotal” or “SumTotal Systems”). For accounting purposes, the merger was treated as an acquisition by Click2learn of Docent. We acquired Pathlore Software Corporation (“Pathlore”), a privately held provider of LMS, on October 4, 2005. We acquired Mindsolve Technologies, Inc. (“MindSolve”), a privately held provider of performance management software, on November 14, 2006.

Company Overview

We are a global provider of talent and learning management solutions. Our solutions include learning management systems and performance and compensation management software and services. We are the market share leader in LMS based on number of customers and revenue, according to a 2006 study by Bersin & Associates, an independent market research firm. Our solutions automate the talent management processes within organizations including aligning individuals’ goals with business objectives, developing the individual’s skills and competencies, assessing the individual’s performance, providing succession planning and setting compensation based on performance. We sell our solutions to organizations primarily through our direct sales force, complemented by sales through our domestic and international partners. We offer our solutions on a license or subscription basis. Our solutions can be deployed at a customer’s site, hosted by us or another hosting provider, or provided on an on-demand basis. We have more than 1,500 customers worldwide across a variety of industries, including education, energy, financial services, government, healthcare, manufacturing, retail, services and utilities.

Industry Overview

Talent Management Market Drivers

Human capital is a critical factor for any organization. In January 2005, HR Magazine stated that as much as 80% of a company’s worth is tied to its human capital. In order to operate and compete effectively, organizations need to recruit, train, evaluate and appropriately compensate their employees. We define these functions as talent management. The goal of talent management is to ensure that people have optimum skills and competencies to achieve the organization’s business objectives.

Challenges which impact successful talent management in today’s market include:

- *Changing Workforce Demographics.* As the population ages in the United States the potential short fall of qualified workers has become a top concern for executives. The Economist, in October 2006, estimated that America’s 500 leading companies will lose approximately 50% of their senior managers over the next five years, and, by

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2025, in Japan, the second largest economy in the world, the number of people aged 15 to 64 is projected to fall by 14%. Because of this demographic shift, talent management solutions are becoming increasingly important to retain workers longer, while simultaneously helping to attract the best new candidates and ensure that knowledge and experience are transferred throughout the organization;

- *Competing in the Global Economy.* As organizations compete globally, the need to ensure alignment of individual goals and development of skills to meet organizational objectives, regardless of location, language, or time-zone, becomes increasingly important;
- *Managing the Extended Enterprise.* As organizations rely more on channel networks and partners to market and sell their products and services, the need to disseminate information and standardize training quickly and broadly both inside and outside the organization becomes critical to the success of its business; and
- *Regulatory and Compliance Requirements.* Legislation and regulations, such as the Sarbanes-Oxley Act and Food and Drug Administration requirements, as well as an organization's internal policies, drive the need to develop, certify and track the knowledge and procedures of individuals more effectively throughout the business system.

Traditional Approaches

Traditionally, organizations used paper-based systems, desktop applications, spreadsheets and human resource management systems (“HRMS”) for their talent management needs. For example, organizations communicate goals through memos and email, manage performance appraisals using word processing programs, register students for training and track completions using spreadsheets, train individuals in a classroom setting and use handwritten notes for succession planning. In these examples, a single, integrated view of an employee's goals, performance appraisals, training and succession plans did not exist. In addition, these traditional approaches are inefficient, costly and lacked the sophistication and specialized functionality that could provide an organization with a competitive advantage in today's market. Traditional approaches often prevent organizations from benefiting from a holistic view of an individual, from goal setting through succession planning.

Talent Management and LMS Solutions

To meet today's talent management challenges, organizations can benefit from implementing technology solutions to manage and automate the talent management processes. Talent management solutions help companies and government agencies around the world achieve measurable improvement in business results in vital areas such as sales, operations, manufacturing, support, finance and marketing. Through strategic and effective talent management, we believe that organizations are able to achieve superior business results by optimizing talent within organizations, as well as their extended enterprise of partners and channels. Talent management solutions enable organizations to more efficiently train individuals to perform their jobs or develop skills for future job opportunities, incentivize individuals based on performance, retain talent through performance-based promotions and ensure that compliance requirements are followed.

Within talent management, LMS is a key solution. According to an independent industry analyst Bersin Associates, in its January 2006 study, “[t]he LMS is one of the only systems in the enterprise that is touched by nearly every employee and manager.” LMS solutions enable organizations to help maximize the productivity of their individuals. LMS, or eLearning, is defined as the

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automation and management of activities related to providing classroom-based training and web-based training, including content creation, facilities and instructor management, student management and compliance and certification tracking. With LMS solutions, organizations can address one or more of the following business challenges:

- new employee training;
- new product launch education;
- partner training;
- sales channel effectiveness;
- certification and regulatory compliance;
- enterprise resource planning (“ERP”) and customer relationship management (“CRM”) system rollout;
- customer service and call center improvement; and
- organizational development and corporate university education.

By addressing these challenges, organizations can achieve a substantial return on investment.

Market Opportunity

According to a 2005 report by The Yankee Group, an independent research firm, the talent management market, which The Yankee Group refers to as the workforce lifecycle management market, is expected to grow from approximately \$1.4 billion in 2005 to \$2.2 billion in 2008, representing a compound annual growth rate of approximately 17%. Each of the market segments within talent management in which we compete is also growing. We believe the LMS market size is approximately \$500 million and growing at approximately the same rate as the overall talent management market. Furthermore, we also believe the performance management market is the fastest growing segment within talent management.

Our Solutions

Our flagship offering, the SumTotal Systems Enterprise Suite (“SumTotal 7 Series”), is an integrated suite of software applications that combines learning management, performance management, compensation management and learning content management. We sell our solutions to organizations in a variety of industry sectors, targeting customers with 300 users to over 100,000 users. Our large customer base includes over 1,500 customers broadly distributed across a variety of industries.

Our solutions are deployed at the customer’s site, hosted by us or another hosting provider or provided on an on-demand basis. We offer our solutions on a license or subscription basis.

The SumTotal 7 Series provides the following key benefits:

- *Talent Management Efficiencies.* Organizations can reduce the time and resources required to track and manage the processes related to goal setting, performance reviews, training schedules and registrations, succession planning, and compensation adjustments. Using our solutions, customers are able to dramatically reduce administrative overhead, travel, and distribution costs as related to training.

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- *Operating Cost Leverage.* Our customers are able to improve productivity of employees, reduce turnover, improve employee satisfaction and reduce the time required to train employees, enabling the operations of the organization to run more efficiently.
- *Reduced Cost of Compliance.* Many of our customers participate in regulated industries. For instance, individuals conducting clinical research must be trained in and comply with Good Clinical Practices, an international ethical and scientific quality standard for clinical trials involving human subjects. Our solutions enable compliance officers to measure training compliance, saving our customers fees and penalties associated with non-compliance.
- *Increased Revenue.* Our solutions enable our customers to achieve faster time to market compared to traditional classroom training, thereby enhancing sales force readiness. For example, a worldwide organization can simultaneously train its employees on a new product days before market introduction, whereas traditional approaches, using worldwide classroom training would take considerably longer.
- *Goal Alignment.* Customers are able to align individual goals to organizational objectives to reduce inefficiencies and improve productivity by ensuring that all employees are working toward the same objectives. By centralizing both organizational and individual goals with goal progress and status, managers and employees can improve their performance.

Our Strengths

The strengths of our business include:

- *Market Share Leader in LMS.* We are the market share leader for LMS based on number of customers and revenue, according to a 2006 report from Bersin & Associates. We believe our market position and brand recognition enhance our ability to be included in competitive selection processes and our large customer base enhances our reputation among potential customers.
- *Global Footprint.* We have a global presence and our solutions support global operations. Our scalable solution has been implemented at many of the world's largest organizations. We believe our global footprint provides a competitive advantage in selling to large, multi-national, multi-lingual organizations that have worldwide locations and needs.
- *Vertical Market Focus.* We have Fortune 500 customers in numerous vertical markets. Each vertical market into which LMS and talent management solutions is sold has its own needs. For example, we have optimized our solutions for customers in the retail industry to operate in stores where point of sales operations constrain Internet bandwidth during business hours and new hire training is critical as annual employee turnover may exceed 100%. Our sales force is organized by vertical markets such as education, energy, financial services, government, healthcare, manufacturing, retail, services and utilities. We believe this industry-focused approach gives us a competitive advantage because our sales force better understands the organization's business.

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- *Robust Product Functionality.* We have developed a feature-rich solution suite with the flexibility to provide a low total cost of ownership for both large and small organizations. Our solution has a high degree of functionality including reporting capabilities and configurability, along with vertical industry functionality that provides a greater return on investment.
- *OEM Partners.* We have developed strong relationships with some of the largest human resource outsourcing companies (“HRO”), who purchase our solutions and install them as part of larger software implementations. Where customers choose to outsource their talent management needs to an HRO, our relationships allow us to reach customers we may not have otherwise been able to reach.

Our Strategy

Our growth strategy is focused on the following objectives:

- *Continue to Grow the Core LMS Business.* Our focus is on expanding our growth within our large installed customer base, acquiring new customers, increasing our international sales and penetrating the small and medium business (“SMB”) market. We plan to:
 - *Further Penetrate Our Customer Base .* While some of our implementations are enterprise wide, many customers have implemented our solutions only in selected divisions or locations. Opportunities exist to further penetrate our customer base by selling additional licenses and modules throughout these customers’ organizations and beyond to their extended organizations.
 - *Acquire New Enterprise Customers .* We believe enterprises will increasingly standardize on one LMS platform, and that we will be able to leverage our position as a leading worldwide LMS vendor to effectively compete for new enterprise customers.
 - *Expand Internationally .* While we have customers spread geographically across the Americas, Europe, the Middle East and Africa, we believe the market outside the United States for LMS solutions remains under-penetrated. As a result, we have taken a number of steps to strengthen our international infrastructure, including strategically increasing the number of international employees and partners. We believe this will result in increased sales to international customers.
 - *Better Penetrate the SMB Market .* We recently enhanced our on-demand solution, which we believe will enable us to better serve potential customers in the SMB market who may not have the budget or IT resources to implement an on-premise enterprise LMS.

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- *Expand Our Performance Management and Compensation Management Customer Base.* As noted above, we believe that performance management is the fastest growing segment within the talent management market. To address this segment more effectively, in November 2006, we acquired MindSolve, a performance and compensation management company. The solution suite we obtained through the acquisition has received positive reviews from industry analysts and includes patented technology that provides, among other things, an intuitive graphical interface for rating and reviewing individuals. We believe that our strong position in the LMS market, coupled with our market-leading solutions, make us well positioned to drive growth in the performance and compensation management markets.
- *Expand Our Talent Management Offerings.* Our LMS customer base provides us with a broad reach within the larger talent management market. Through acquisition, product development and partnerships, we expect to further expand our product offerings in talent management.
- *Generate Partner Leverage.* We intend to pursue opportunities to add additional partners who will embed our solutions in their broader offerings. Potential partners include HROs, OEMs and other software companies.

Products and Services

We are a global provider of talent and learning management solutions. With the SumTotal 7 Series, we provide organizations with a single solution for managing their talent management needs—from goal setting to employee training and development to pay-for-performance to career development. Our integrated offering enables employees, managers and human resources personnel to manage performance objectives, conduct training, measure progress and plan and set compensation, all of which we believe will improve productivity and increase revenue and profitability. Furthermore, organizations can report, measure and analyze the impact of talent on desired business results and effectively manage performance.

The SumTotal on-demand solution, known as ResultsOnDemand, offers organizations an affordable and fast implementation solution with enterprise-class talent and learning management capabilities. ResultsOnDemand operates in a segmented multiple customer, or multi-tenant, environment with bundled services that reduce the technical and functional administration usually associated with on-premise or hosted applications. With ResultsOnDemand, customers are provided with a personalized solution that includes their own branded interface, configured emails and notifications and tailored reports. All of the SumTotal 7 Series products are available as an on-demand solution.

SumTotal 7 Series

The SumTotal 7 Series aligns individuals' goals with organizational goals, prescribes learning plans and training, tracks certification and compliance related activities and correlates training with business results. The SumTotal 7 Series is an open, flexible and scalable web-based system that is configurable to the unique and changing needs of a customer. The suite of ten software solutions unifies collaborative content development, comprehensive learning management, knowledge management, performance management, real-time collaboration, and analytics into an integrated system. The SumTotal 7 Series is a global platform and is available in over 20 languages.

The SumTotal 7 Series solutions can be integrated with other enterprise applications, such as systems for enterprise resource planning, supply chain and customer relationship management, human resources, e-commerce and financial management. The SumTotal 7 Series includes the following modules:

- *TotalLMS.* TotalLMS is a module for managing learners, content and resources. Organizations can centrally prescribe personalized training to individuals while segmenting functionality and data based on organizational structures such as location, department or customer. Individuals can take training via a variety of methods, including self-paced web, live interactive web, instructor-led, on-the-job, seminars, mentoring and written documentation.

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- *TotalPerformance.* TotalPerformance is a module that enables organizations to establish and communicate critical corporate goals, measure performance and ensure that individuals and groups at all levels of the organization are aligned with business objectives. In addition, TotalPerformance provides organizations with the ability to manage talent strategically and plan for employee succession, career development and organizational workforce needs. TotalPerformance includes patented technology that provides, among other things, an intuitive graphical interface for rating and reviewing individuals.
- *TotalCompensation.* TotalCompensation is a module that enables organizations to manage and adjust employee compensation based on performance evaluations, competency ratings and other factors. Both managers and human resources professionals have the ability to adjust base salary, bonuses, cost of living, stock options and other compensation variables.
- *TotalAccess.* TotalAccess is a desktop module that provides a comprehensive, online learning environment without requiring a connection to the network, enabling users to access their learning offline through one-click downloads to their personal computer, and, when re-connected, one-click uploads to the server.
- *TotalLCMS.* TotalLCMS is a web-based module for training and simulation that enables team-based content creation, authoring and collaborative development for instructional designers, subject matter experts, project managers and reviewers.
- *TotalDashboard.* TotalDashboard is an end-to-end analytics module that provides executives and training professionals with business insight by providing users with interactive, role-based dashboards that correlate training activities with performance data from CRM, Human Resources, ERP, or legacy systems.
- *TotalVersioning.* TotalVersioning is a module that automates the process of managing and tracking multiple versions of a learning activity and produces complete sets of reports for compliance management.
- *TotalVCS.* TotalVCS is a module that enables live communication, collaboration and learning over the web for the delivery of real-time online training. TotalVCS allows organizations to capture and categorize virtual classroom sessions, eliminating the time and expense of travel and bringing geographically dispersed users together anytime, anywhere.
- *TotalCollaboration.* TotalCollaboration is a module that provides an interactive forum for employees to obtain information from experts and for organizations to capture information for future reference. TotalCollaboration enables employees to obtain immediate answers from experts via threaded discussions, enhancing an organization's productivity and knowledge base.

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- *TotalInformation.* TotalInformation is a module that allows organizations to extend the learning experience beyond formal courseware to informal content and information by allowing individuals to quickly search, browse and access informal content such as documents, job-aids and video.

ToolBook Solution

Our ToolBook Instructor and ToolBook Assistant enterprise learning content creation solutions are targeted at small teams and individual authors that require a robust, desktop instructional-design capability. These solutions enable our ToolBook customers to create their own media-rich interactive learning content for deployment on TotalLMS, other standards-compliant learning management systems or CD-ROMs. ToolBook Instructor, targeted at professional software developers, is a multimedia development system for creating sophisticated applications and simulations. ToolBook Assistant, targeted at learning professionals and content experts, is an easy-to-use authoring product that automates much of the process of developing learning applications. Both solutions are licensed on a per copy, perpetual basis.

Phoenix and Preference Solution

We also provide solutions targeted at organizations that require a robust, computer-based training (“CBT”) and online help solution for the mainframe environment. Our Phoenix solution offers authoring, administration, presentation and reporting on IBM and IBM-compatible mainframes, allowing organizations to manage all phases of the CBT life cycle from design through evaluation. Our Preference solution is a centralized online help and reference system that works concurrently with existing mainframe applications helping to solve the immediate problems of workers who use these mainframe applications to perform their jobs.

Services

We complement our product solutions with a range of services to enable organizations to implement, evaluate and maintain their enterprise learning solutions. We typically bill organizations for these services on a time and materials basis. Our service offerings include:

- *Professional Services.* Our range of professional services includes needs assessment, project management, on-site technical implementation services, employee competency and profile development, curriculum planning and content development, system integration and services associated with system upgrades. A variety of solution packages are offered for accelerated deployment and system rollouts.
- *Technical Support.* We provide global customer support before, during and after installation of our software solutions. Assistance in the use of our solutions is available from technical support engineers by domestic and international e-mail, telephone, or through our self-service knowledge base. Support is typically provided on an annual contract basis, which includes software updates, bug fixes, documentation, and patches.

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- *Hosting.* We offer comprehensive hosting services that allow extended enterprises to successfully deploy our applications with minimal IT infrastructure and resources. Through our dedicated application hosting services, our customers receive worldwide access to our learning applications.
- *Training.* We offer a comprehensive range of customer and partner training programs that are available online as well as in an instructor-led format at our facilities and customer sites.
- *BPO.* We offer a set of managed services for business process outsourcers (“BPO”) to outsource the administration and support for each of our software solutions. BPO customers receive end user support, ongoing system administration, ongoing custom report design and delivery, regular contact with customers to review, analyze and improve operations, post-implementation process design consultation and end-user training.
- *Content.* We offer a range of third party content from our content partners that address industry-specific and solution area needs .

Technology, Research & Development

Our solutions are designed on a standards-based, open and scalable architecture, are web-based and are accessible by users through standard web browsers. As a result, our infrastructure supports large numbers of individual users and organizations across the globe. The architecture has been designed to allow content and results from multiple organizations to be aggregated easily and delivered to anyone using a variety of Internet enabled devices. This allows information to reach a diverse set of internal and external participants with minimal deployment and maintenance costs.

Our efforts and expenditures in research and development are devoted to continually enhancing the functionality and scalability of our current product offerings and the development of new products. Our research and development expenditures are expensed as incurred. These expenses were \$18.7 million, \$12.4 million and \$12.9 million for the years ended December 31, 2006, 2005 and 2004, respectively, and represented 17.6%, 16.5% and 23.3%, respectively, of total revenue from operations in those periods. These expenses for the years ended December 31, 2006 and 2004 include charges for in-process research and development of \$1.1 million and \$1.3 million, respectively, which were written off in conjunction with our purchase accounting for the MindSolve and Docent acquisitions. See Note 6 *Acquisitions and Intangible Assets* to the Notes to the Consolidated Financial Statements for additional detail.

Our solutions are designed to support leading relational database management systems, including Oracle and Microsoft SQL Server. We support multiple operating systems and hardware configurations to meet the differing needs of our customers. Our software incorporates third party software in addition to code that we have developed ourselves. Server applications are based on standard web server technology and are implemented in Java, ASP, C#, or C++ with both native and standards-based connectivity to both the web server and the database. Key features of our technology include:

- *Scalable Platform.* Our solutions are designed to run in a single or clustered application server environment, allowing individual hardware platforms to be sized to the specific needs of a customer. We are also able to add content servers in one or more geographic locations to provide the capacity to handle large courses and types of content to reduce network constrictions.

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- *Multiple Simultaneous Cultures.* Our solutions have been designed to allow support for multiple simultaneous cultures from a single instance of the application. This includes such features as the support for multiple simultaneous languages (both single- and double-byte) from a single application server as well as the support of multiple currencies in a single system.
- *Ease of Implementation.* Our solutions have been designed to be easily tailored to an organization's business environment. Our system configuration enables administrators to control all aspects of the system including the functionality, workflows, notifications, reports and user interface. In addition, advanced use of web services and delivery of a web services Software Development Kit ("SDK") allows organizations to easily integrate our solutions within their existing environments. A standard system can be quickly and easily deployed using automated installation scripts.
- *Standards-Based Open Architecture.* We provide direct and standards-based connections to industry standard databases and web servers. Our solution infrastructure is based on standard Internet architectures and protocols. We support standards activities in the learning management arena, and our system is compatible with the Aviation Industry CBT Committee ("AICC") AGR-010 Internet-based course management interface standards. We are also in conformance with the U.S. Department of Defense ("DOD") Advanced Distance Learning ("ADL") initiatives SCORM version 1.2 and 2004 specifications and the IMS metadata tagging version 1.0 specification.
- *Remote and Wireless Operations.* Our solutions provide a number of capabilities to allow for remote and wireless operations. These include hybrid web/CD-ROM deliverables that enable organizations to make more effective use of limited network bandwidth. Our TotalAccess application allows users to access their learning offline through one-click downloads to their laptop, and, when re-connected, one-click uploads to the server. Our technology platform also allows us to deliver solutions through Internet enabled devices.

Backlog

As of December 31, 2006 and 2005, we had firm backlog orders of approximately \$64 million and \$54 million, respectively. Backlog includes all deferred revenue, and contractual commitments where the customer has not yet been billed. Backlog consists primarily of support contracts for our license products, hosting contracts, implementation services work contracted but not performed, the unperformed portion of our on-demand subscriptions and licenses with unfulfilled product deliverables or acceptances. Although we expect that most of the current backlog will be recognized as revenue over the next 12 months, there is no assurance that all such backlog will be recognized over the next 12 months, or at all.

Sales and Marketing

In the United States and Canada, we sell our solutions primarily through direct sales operations, and our direct sales force is divided by geographic region and vertical industry to provide a higher level of service and understanding of our customer's specific business requirements. In Europe, we sell through both direct sales operations and resellers. In Latin America, the Middle East, Africa and Asia/Pacific, we sell primarily through resellers.

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We also have telesales representatives focused on certain product lines SMB smaller customers. Our sales organization also includes sales engineers who provide technical expertise, architect the technical aspects of our enterprise learning solutions, assist in proposal preparation and provide ongoing sales support.

We conduct a variety of marketing programs to promote our talent and learning management solutions, including advertising in national business and technology magazines and trade publications, attending major trade shows, conducting direct mail and e-mail campaigns, public seminars, web-based seminars and public relations activities focused on company news and successful applications of our solutions. As a leading provider of talent and learning technologies, we participate as an exhibitor and speaker at numerous trade shows. We also maintain an area on our website where potential customers can obtain information about our solutions.

Revenue by geographic region is based on the direct billing location of the customer and is as follows (in thousands, except percentages):

	Year Ended December 31,					
	2006		2005		2004	
	Revenue	Percent of Revenue	Revenue	Percent of Revenue	Revenue	Percent of Revenue
United States	\$ 83,861	79%	\$55,881	75%	\$39,286	71%
Other Americas	5,148	5%	3,187	4%	1,159	2%
Total Americas	89,009	84%	59,068	79%	40,445	73%
Europe	13,050	12%	13,034	17%	12,327	22%
Asia/Pacific	3,929	4%	2,868	4%	2,432	5%
	<u>\$105,988</u>	<u>100%</u>	<u>\$74,970</u>	<u>100%</u>	<u>\$55,204</u>	<u>100%</u>

Alliances

Content Partners

Our content partners provide specialized off-the-shelf content specific to industries and subject areas that are certified by us to be compatible with the SumTotal 7 Series. Our content certification program provides development licenses and a third party testing environment to ensure interoperability. Additionally, our content partners may also provide custom development capabilities for our customers. Our content partners include Element K, Harvard Business School Publishing eLearning and SkillSoft.

Solutions Integrators

Our solutions integration partners resell our software and/or services as part of their value-added solution. We have alliances with large global system integrators and consulting firms in North America, Europe, and Asia Pacific.

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Human Resource Outsourcers

We also have formed alliances with several HROs that include our talent and learning solutions as part of a complete HRMS outsourced solution.

Technology Partners

Our technology partners provide complementary technology, such as enterprise application integration, performance management, content management and synchronous web collaboration technologies that extend the value of the SumTotal solution.

Customers

We provide our talent and learning management solutions to over 1,500 customers covering 15 million users, and including approximately one half of the Fortune 100 across a broad range of geographies and industries. We serve clients in a variety of industries such as education, energy, financial services, government, healthcare, manufacturing, retail, services and utilities. No customer accounted for greater than 10% of our total consolidated revenue in 2006, 2005 or 2004.

Competition

We compete primarily in the talent and learning management markets that are comprised of providers of software solutions for business learning and performance management needs. We compete in the learning management, learning content management, authoring, performance management and compensation management segments of these markets. The market for our products and services is highly competitive and subject to rapid change. Furthermore, it is a dynamic industry in which there has been consolidation, which we expect to continue.

We encounter competition from a variety of sources:

- eLearning suite vendors who provide learning management systems, learning content management systems and other learning offerings, including Plateau and Saba;
- enterprise application software vendors who are extending their ERP, CRM, and HRMS offerings with learning management and/or content development products, including IBM, Oracle, and SAP;
- eLearning application service providers who provide subscription-based Internet learning applications and content, including GeoLearning and Learn.com;
- performance management software vendors who provide goal management, performance appraisal and succession planning capabilities, including Halogen Software and SuccessFactors;
- talent management software vendors who provide multiple applications within the talent management segments such as recruiting, compensation, performance management or learning management, including Authoria and Kenexa; and
- customer in-house development programs.

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We believe that competitive differentiation is influenced by the following factors:

- size and success of customer base;
- customer service and satisfaction;
- breadth of product line capabilities;
-

support for prevailing technology standards and web architectures;

- professional services capabilities;
- pricing; and
- geographic coverage and channels.

We believe our solutions compete favorably with respect to these factors.

Our ToolBook products face competition from other web authoring products. New competitors may enter this market in the future because there are relatively low barriers.

Intellectual Property Rights

Our success and ability to compete effectively is dependent on our ability to develop and maintain the proprietary aspects of our technology and to operate without infringing on the intellectual property rights of others. We rely on a combination of trade secrets, copyrights and trademarks, as well as contractual restrictions to protect the proprietary aspects of our technology. In addition, as part of our acquisition of MindSolve, we obtained its patent on “Drag and Drop” technology and, as a result, patent protection may become a more important component of the methods we use to protect proprietary aspects of our technology. However, these legal protections afford only limited protection for our technology. We seek to protect the source code for our software, documentation and other written materials under trade secret and copyright laws. We license our software pursuant to signed license or “shrink-wrap” agreements, which impose restrictions on the licensee’s ability to use the software. Finally, we seek to avoid disclosure of our intellectual property by requiring employees and consultants with access to proprietary information to execute confidentiality agreements with us and by restricting access to our source code. Due to rapid technological change, we believe factors such as the technological and creative skills of our personnel and new product developments and enhancements to existing products may be more important to establishing and maintaining a technology leadership position than the various legal protections of our technology.