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 ended September 30, 2007

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 filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (check one)

☐ Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.): Yes ☐ No ☒

The number of shares outstanding of the issuer's common stock, par value $0.001, as of October 31, 2007 was 32,409,799 shares.

SUMTOTAL SYSTEMS, INC.

FORM 10–Q

For the Quarter Ended

September 30, 2007

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PART I – FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

SUMTOTAL SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited, in thousands except for share and per-share data)

	September 30, 2007	December 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 29,471	$ 10,176
Restricted cash	—	23
Short-term investments, at cost which approximates market	22,282	5,530
Accounts receivable, net of allowance for sales returns and doubtful accounts of $686 and $899, respectively	22,830	28,516
Prepaid expenses and other current assets	5,438	3,891
Total current assets	80,021	48,136
Property and equipment, net	7,604	5,945
Goodwill	68,461	68,461
Intangible assets, net	14,975	21,327
Other assets	1,119	1,194
Total assets	$ 172,180	$ 145,063
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 2,544	$ 3,991
Accrued compensation and benefits	7,217	8,554
Other accrued liabilities	3,842	4,612
Restructuring accrual	28	866
Deferred revenue	34,138	29,958
Notes payable	6,187	6,095
Total current liabilities	53,956	54,076
Non-current liabilities:		
Other accrued liabilities	210	246
Deferred revenue	779	781
Notes payable	6,686	10,735
Total liabilities	61,631	65,838
Commitments and contingencies		
Stockholders' equity:		
Preferred stock; $0.001 par value; 5,000,000 shares authorized; no shares issued and outstanding	—	—
Common stock; $0.001 par value; 100,000,000 shares authorized; 32,385,456 and 26,837,235 shares issued and outstanding	33	27
Additional paid-in capital	393,796	354,800
Treasury stock: 383,300 shares at September 30, 2007, at cost	(2,141)	—
Accumulated other comprehensive loss	(325)	(332)
Accumulated deficit	(280,814)	(275,270)
Total stockholders' equity	110,549	79,225
Total liabilities and stockholders' equity	$ 172,180	$ 145,063

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

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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,	
	2007	**2006**	**2007**	**2006**
Revenue:				
Subscriptions and support	$15,669	$12,222	$45,241	$34,858
Service	8,338	8,241	24,550	22,185
License	5,310	6,491	18,802	19,317
Total revenue	29,317	26,954	88,593	76,360
Cost of revenue:				
Subscriptions and support	5,383	3,822	15,295	10,934
Service	4,986	6,027	16,212	16,326
License	125	289	417	632
Amortization of acquired intangible assets	2,051	2,090	6,352	6,586
Total cost of revenue	12,545	12,228	38,276	34,478
Gross margin	16,772	14,726	50,317	41,882
Operating expenses:				
Research and development	5,400	4,572	15,697	12,711
Sales and marketing	8,700	7,895	25,557	22,760
General and administrative	4,915	4,571	14,335	15,123
Restructuring charge	—	68	—	68
Total operating expenses	19,015	17,106	55,589	50,662
Loss from operations	(2,243)	(2,380)	(5,272)	(8,780)
Interest expense	(304)	(429)	(1,047)	(1,295)
Interest income	683	180	1,224	532
Other, net	(13)	(49)	(56)	131
Loss before provision for income taxes	(1,877)	(2,678)	(5,151)	(9,412)
Provision for income taxes	119	12	190	7
Net loss	$ (1,996)	$ (2,690)	$ (5,341)	$ (9,419)
Net loss per share, basic and diluted	$ (0.06)	$ (0.11)	$ (0.18)	$ (0.38)
Weighted average common shares outstanding, basic and diluted	32,473	25,131	29,781	24,914

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

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

	Nine-Months Ended September 30,	
	2007	2006
Cash flows from operating activities:		
Net loss	$ (5,341)	$ (9,419)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	2,930	2,159
Amortization of intangible assets	6,352	6,586
Recovery of allowances for sales returns and doubtful accounts	(64)	(175)
Accretion of interest income on short-term investments	(165)	(30)
Amortization of discount on notes payable	200	171
Stock-based compensation	3,423	3,128
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable, net	5,983	2,571
Prepaid expenses and other assets	(1,579)	80
Other assets	107	404
Accounts payable	(1,479)	845
Accrued compensation and benefits	(1,392)	980
Other accrued liabilities	(1,051)	201
Restructuring accrual	(838)	(1,612)
Deferred revenue	4,036	(1,684)
Net cash provided by operating activities	11,122	4,205
Cash flows from investing activities:		
Purchases of property and equipment	(4,366)	(3,276)
Purchases of short-term investments	(27,603)	(4,502)
Sales and maturities of short-term investments	11,075	1,014
Release of restricted cash	23	110
Net cash used in investing activities	(20,871)	(6,654)
Cash flows from financing activities:		
Net proceeds from the issuance of common stock pursuant to registered direct offering	32,710	—
Repayment of credit facility	(3,281)	(3,281)
Payment on notes payable	(876)	(1,085)
Purchases of treasury stock	(2,141)	—
Net proceeds from the issuance of common stock pursuant to employee benefit plans	2,869	2,338
Net cash provided by (used in) financing activities	29,281	(2,028)
Effect of foreign exchange rate changes on cash and cash equivalents	(237)	(430)
Net increase (decrease) in cash and cash equivalents	19,295	(4,907)
Cash and cash equivalents at beginning of period	10,176	18,356
Cash and cash equivalents at end of period	$ 29,471	$13,449
Supplemental disclosure of cash flow information		
Interest paid	$ 935	$ 990
Taxes paid	$ 45	$ 9

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

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

NOTE 1: DESCRIPTION OF BUSINESS

SumTotal Systems, Inc. ("SumTotal Systems") develops markets, distributes and supports learning management and performance management software products and on-demand subscriptions. SumTotal Systems' markets are worldwide and include a broad range of industries.

NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying financial data as of September 30, 2007, and for the three and nine-months periods ended September 30, 2007 and 2006, respectively, 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 ("GAAP") have been condensed or omitted pursuant to such rules and regulations. Certain other amounts have been reclassified to conform to the current period presentation. The December 31, 2006 condensed consolidated balance sheet was derived from audited consolidated financial statements, but does not include all disclosures required by GAAP.

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. There were no significant changes in the accounting policies that occurred during the three and nine-month periods ended September 30, 2007 from those policies outlined in the Annual Report of Form 10-K which was filed with the SEC on March 16, 2007 that have materially affected the financial reporting unless specifically outlined in these unaudited notes to the Condensed Consolidated Financial Statements. This Quarterly Report on Form 10-Q should be read in conjunction with SumTotal Systems' audited consolidated financial statements contained in the Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission.

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 GAAP 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 adequacy of other assumptions. On an ongoing basis, SumTotal Systems evaluates estimates, including those related to revenue recognition, allowance for sales returns and doubtful accounts, potential impairment of intangible assets, restructuring reserves, stock-based compensation and valuation reserves for deferred tax assets and income tax expense. Actual results could differ from those estimates.

Reclassification

Certain amounts in the prior period's financial statements and related notes have been reclassified to conform to the 2007 presentation. These reclassifications have no material impact on previously reported net loss.

Revenue Classification

SumTotal Systems derives its revenue from three sources: (1) the sales of on-demand subscriptions, maintenance and support services, hosting arrangements, and term license rental arrangements; (2) the sales of services performed in connection with consulting agreements and other "service transactions" as defined in the American Institute of Certified Public Accountants ("AICPA") Statement of Position ("SOP") No. 97-2, *Software Revenue Recognition* , as amended; and (3) the sales of software licenses and related royalty arrangements.

Revenue Recognition

Revenue from SumTotal Systems' on-demand subscriptions is recognized in accordance with SEC Staff Accounting Bulletin ("SAB") No. 101, *Revenue Recognition in Financial Statements* , as amended by SAB No. 104, *Revenue Recognition.* Revenue derived from software products is subject to the guidance and requirements of SOP No. 97-2, as amended by SOP No. 98-9, *Software Revenue Recognition with Respect to Certain Arrangements* . In the event of a multiple element arrangement, SumTotal Systems evaluates the transaction as if each element represents a separate unit of accounting taking into account all factors following the guidelines set forth in SOP No. 97-2 and the Financial Accounting Standards Board ("FASB") Emerging Issues Task Force Issue ("EITF") No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables* . Where the services are essential to the functionality of the software element of the arrangement and separate accounting for the services is not permitted, contract accounting is applied to both the software and service elements. For these projects, revenue is recognized in accordance with SOP No. 81-1, *Accounting for Performance of Construction Type and Certain Production Type Contracts* , typically on a percentage-of-completion basis as evidenced by labor hours incurred to estimated total labor hours. The application of the appropriate accounting principle to SumTotal Systems' revenue is dependent upon the specific transaction and whether the sale includes software and software-related products, on-demand subscriptions, services, or a combination of these items.

For all sales, 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 collectability is reasonably assured.

SumTotal Systems typically uses either a binding purchase order or signed agreement, depending on the nature of the transaction, as evidence of an arrangement. In addition, 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 refund or forfeiture, concession or other adjustment, then SumTotal Systems 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, the geographic location and financial viability. SumTotal Systems does not request, nor does it require, collateral from customers. If the determination is made at the time of the transaction that collection of the fee is not reasonably assured, then all of the related revenue is deferred until the time that collection becomes reasonably assured.

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 customization, consulting services, or the services are not considered essential to the functionality of the licenses, delivery is deemed to occur when the product is shipped, or the access key is provided, to the customer. Services and consulting arrangements that are not essential to the functionality of the licensed product are recognized as revenue as these services are provided. Delivery of on-demand subscriptions, hosting agreements and support agreements is generally considered to occur and revenue recognized on a straight-line basis over the life of the contract.

Allowances provided for estimated returns and discounts are recorded when the revenue is initially recognized and such allowances are adjusted periodically to reflect actual and anticipated experience.

Distributors, resellers 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 SumTotal Systems' software to end users and do not provide for product rotation or pricing allowances, as are typically found in agreements with stocking distributors. 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.

Revenue from sales of third-party products, net of royalties to third-party companies, is 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 these sales 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:

- acts as principal in the transaction;

- takes title to the products;
- has risks and rewards of ownership, such as the risk of loss for collection, delivery, or returns; and
- acts as an agent or broker with compensation on a commission or fee basis.

These sales are typically recorded on a gross basis.

Software Products

Sales of software products and related services that are subject to the guidance of SOP No. 97-2 as amended by SOP No. 98-9 are recognized as follows:

For deliverables and multiple element arrangements subject to SOP No. 97-2, as amended by SOP No. 98-9, 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 and product post contract support and 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 of standard products based upon the amounts SumTotal Systems charges when support and hosting are sold separately and/or renewals to other customers or upon renewal rates quoted in contracts when the quoted renewal rates are deemed substantive. 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.

Time-based license sales which always include post-contract support ("PCS"), may or may not include installation services that do not involve significant production, modification, or customization of software and may or may not include hosting services. These time-based license sales are recognized in accordance with paragraph 12 of SOP No. 97-2 because company-specific objective evidence of fair value does not exist for the related post contract support and in cases where SumTotal Systems provides hosting for the customer, for the hosting element. As these arrangements are in essence subscriptions, SumTotal Systems recognizes revenue for the entire arrangement fee ratably over the longest performance period of these elements beginning at the time the customer has been provided access to the time-based license and can utilize the software, and after all other criteria for revenue recognition have been met. Delivery of the time-based license is considered to occur at the time when the customer has been provided with the necessary logon and access information required to utilize the time-based license, delivery of the PCS and hosting is generally considered to occur on a straight-line basis over the term of the contract, and delivery of the services (if included in the arrangement) that do not involve significant production, modification, or customization of software, is considered to occur as these services are delivered.

Many of SumTotal Systems' software contracts include consulting implementation services. Consulting revenue from certain of these contracts is generally accounted for separately from the perpetual license revenue 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 (e.g., 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. Revenue for consulting services is 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 not subject to final customer acceptance, 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 require significant customization, modification or production of the software, or where software services are otherwise considered essential and separate accounting for the services is not permitted, SumTotal Systems recognizes revenue using contract accounting for both the software and service elements. For these projects, revenue is recognized in accordance with SOP No. 81-1, typically on a percentage-of-completion basis as evidenced by labor hours incurred to estimated total labor hours. The percentage-of-completion methodology generally results in the recognition of reasonably consistent profit margins over the life of the contract since SumTotal Systems has the ability to produce reasonably dependable estimates of contract billings and contract costs. Amounts recognized in revenue are calculated using the progress-to-completion measurement after giving effect to any changes in 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 it is first determined that a loss is apparent. Amounts billed in excess of revenue recognized are recorded as deferred revenue in the accompanying consolidated balance sheets. Revenue recognized in accordance with SOP No. 81-1 is allocated for classification purposes in the statement of operations between license and service revenues based on an estimate of the fair value of the service portion of the arrangement as indicated by rates that SumTotal Systems separately sells similar services and use of the residual method for the license component.

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. When total cost estimates exceed revenue, SumTotal Systems accrues for the estimated losses immediately based upon an average fully burdened daily rate applicable to the consulting organization delivering the services. 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 SumTotal Systems' operating results. A number of internal and external factors can affect SumTotal Systems' 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 SumTotal Systems' server or a third party's server for a monthly fee and an initial set-up fee. Based on the criteria outlined in EITF No. 00-03, *Application of AICPA SOP 97-2, Software Revenue Recognition, to Arrangements that Include the Right to Use Software Stored on Another Entity's Hardware* , SumTotal Systems has determined that the vast majority of 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. In cases where the hosting arrangement falls outside of the scope of SOP No. 97-2, SumTotal Systems applies the provisions of SAB No. 104 to the arrangement. The costs of these services are recognized as incurred and included as a component in costs of services revenue.

On-Demand Subscriptions

These are subscriptions where the customer has purchased a bundled product that includes the use of a license over a term, hosting, maintenance and support and consulting services, and are all reported as service revenue. Under the terms and conditions of these on-demand sales, SumTotal Systems' customers can only access services via SumTotal Systems' hosted environment and they do not have the right of refund once their term has commenced. Therefore, these customers do not have the right to take possession of the software at any time during the hosting period without significant penalty, nor is it feasible for these customers to run the software on their own hardware or contract with another party unrelated to SumTotal Systems to host the software. In accordance with EITF No. 00-03,rrangements that do not give the customer such options are service contracts and are outside of the scope of SOP No. 97-2. Accordingly, SumTotal Systems recognizes revenue for these arrangements in accordance with the guidance provided by SAB No. 104. This revenue is included as a component of service, maintenance and other revenue on the accompanying consolidated statement of operations.

Based on the guidance of EITF No. 00-21, SumTotal Systems notes that the individual elements contained within each on-demand subscription sale do not have value to the customer on a stand-alone basis. As these specific elements are currently only provided by SumTotal Systems and are not sold separately, SumTotal Systems does not have evidence of the fair value for these elements. Further, as these customers are in fact purchasing an ongoing service activity and not discrete setup activities, the sales of SumTotal Systems' on-demand subscriptions are considered to be a single unit of accounting in accordance with specific guidance. As these services are performed continuously through the contractual term of the arrangement revenue is recognized ratably over the contractual term as there is no other discernable pattern of service delivery and no other evidence suggesting that the revenue is earned or that the obligations are fulfilled in a different pattern.

Transactions including both Software Products and On-Demand Subscriptions

For multiple element arrangements that contain both software products and on-demand subscriptions, SumTotal Systems evaluates the arrangement based on EITF No. 03-05, *Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software* . In accordance with the provisions of EITF No. 03-05, when the arrangement contains one or more deliverables for which the functionality is not dependent on the software, the arrangement fee is allocated between the "non-software" and software deliverables in accordance with EITF No. 00-21 if the following criteria are met:

- the delivered item has stand alone value;
- there is objective and reliable evidence of the fair value of the undelivered elements as demonstrated by vendor-specific objective evidence or third party evidence; and
- if the arrangement includes a general return right relative to the delivered item, delivery or performance of the undelivered item is considered probable and substantially in the control of the vendor.

If the above criteria are met, SumTotal Systems allocates the arrangement fee to the delivered items using the residual value method. Revenue for the elements whose functionality is not dependent upon the delivered software is recognized in accordance with SAB No. 104 and revenue for software elements is recognized in accordance with SOP No. 97-2. If the above criteria are not met, all deliverables are considered a single unit of accounting and revenue is normally recognized in accordance with SOP No. 97-2. The subscription fees from clients accessing SumTotal Systems' on-demand software and consulting services are recognized in accordance with SAB No. 104.

Deferred Revenue

Deferred revenue represents advanced payments for software licenses, services, maintenance and support, subscription services and hosting arrangements in advance of the time SumTotal Systems recognizes revenue. These deferred amounts are expected to be recognized as revenue based on the revenue policy outlined above.

Income Taxes

In June 2006, the FASB issued Interpretation ("FIN") No. 48, *Accounting for Uncertainty in Income Taxes* . FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards ("SFAS") No. 109, *Accounting for Income Taxes* . This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on de-recognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. SumTotal Systems adopted FIN No. 48 effective January 1, 2007.

As a result of the implementation of FIN No. 48, SumTotal Systems recognized a $0.3 million increase in liability for unrecognized tax benefits, which was accounted for as a $0.2 million reduction to the January 1, 2007 balance of retained earnings and as a $0.1 million increase in deferred tax assets . SumTotal Systems has a liability for unrecognized tax benefits of approximately $0.3 million as of January 1, 2007, all of which if recognized would result in a reduction of SumTotal System's effective tax rate. SumTotal Systems recorded no increase to its liability for unrecognized tax benefits as of September 30, 2007. In accordance with FIN No. 48, SumTotal Systems has decided to classify interest and penalties related to income taxes as a component of income tax expense. Interest and penalties are immaterial at the date of adoption and are included in the unrecognized tax benefits. SumTotal Systems is subject to audit by various taxing authorities for open returns from 2000 through 2006.

Net 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. For the three and nine-months ended September 30, 2007, 92,500 shares held in escrow for the MindSolve acquisition are not included in the weighted average number of common shares outstanding during the period for both basic and diluted net loss per share. For the three and nine-months ended September 30, 2006, 391,665 shares held in escrow for the Pathlore acquisition were not included in the weighted average number of common shares outstanding during the period for both basic and diluted net loss per share. As SumTotal Systems had a net loss for each of the periods presented, basic and diluted net loss per share are the same since the inclusion of potential common stock would be anti-dilutive. 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 loss per share for the three and nine-months ended September 30, 2007 and 2006 (in thousands, except per share amounts):

	Three-Months Ended September 30,		Nine-Months Ended September 30,	
	2007	2006	2007	2006
Net loss	$ (1,996)	$ (2,690)	$ (5,341)	$ (9,419)
Weighted average common shares used to compute basic and diluted net loss per share	32,473	25,131	29,781	24,914
Net loss per share, basic and diluted	$ (0.06)	$ (0.11)	$ (0. 18)	$ (0.38)

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, 2007 and 2006 (in thousands, except weighted average prices):

	Three-Months Ended September 30,		Nine-Months Ended September 30,	
	2007	2006	2007	2006
Options to acquire shares of common stock	2,133	2,755	1,886	2,827
Weighted average option exercise price	$ 10.23	$ 10.15	$ 10.68	$ 10.04
Warrants to acquire shares of common stock	1,424	1,577	1,424	1,577
Weighted average warrant price	$ 7.54	$ 7.67	$ 7.54	$ 7.67

Comprehensive Loss and Accumulated Other Comprehensive Loss

The following table sets forth the components of comprehensive loss for the three and nine-months ended September 30, 2007 and 2006 presented below (in thousands):

	Three-Months Ended September 30,		Nine-Months Ended September 30,	
	2007	2006	2007	2006
Net loss	$(1,996)	$(2,690)	$(5,341)	$(9,419)
Unrealized gain on investments	13	2	11	2
Foreign currency translation loss adjustments	(8)	(100)	(4)	(480)
Comprehensive loss	$(1,991)	$(2,788)	$(5,334)	$(9,897)

SumTotal Systems' total comprehensive loss for the three and nine-months ended September 30, 2007 and 2006 consisted of net loss, unrealized 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 loss consists of foreign currency translation loss adjustments of $336,000 and $332,000 at September 30, 2007 and December 31, 2006, respectively, and an unrealized gain on investments of $11,000 at September 30, 2007.

Stock-Based Compensation

On January 1, 2006, SumTotal Systems adopted SFAS No. 123R, *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. In March 2005, the SEC issued SAB No. 107, *Share-Based Payment,* relating to SFAS No. 123R. SumTotal Systems applied the provisions of SAB No. 107 in the adoption of SFAS No. 123R.

SumTotal Systems adopted SFAS No. 123R using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of fiscal 2006. The consolidated financial statements as of and for the year ended December 31, 2006 reflect the impact of SFAS No. 123R.

Valuation and Expense Information under SFAS No. 123R

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 below are based on the following weighted average assumptions:

	Three-Months Ended September 30, 2007	Nine-Months Ended September 30, 2007
Risk-free interest rate	4.60%	4.69%
Expected volatility	85.40%	88.91%
Expected life (years)	6.25	6.15

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

The weighted-average fair value calculations for SumTotal Systems' employee stock purchase plan ("ESPP") within the periods below are based on the following weighted average assumptions:

	Three-Months Ended September 30, 2007	Nine-Months Ended September 30, 2007
Risk-free interest rate	4.96%	5.05%
Expected volatility	57.05%	54.87%
Expected life (years)	0.50	0.50

The following table summarizes stock-based compensation expense related to employee stock options, ESPP and restricted stock units under SFAS No. 123R for the three-months ended September 30, 2007 and 2006, respectively, and were allocated as follows (in thousands):

	Three-Months Ended September 30, 2007	Three-Months Ended September 30, 2006
Subscriptions and support	$ 81	$ 76
Service	147	196
Cost of revenue	228	272
Research and development	156	138
Sales and marketing	266	288
General and administrative	632	420
Stock-based compensation expense included in operating expenses	1,054	846
Total stock-based compensation expense	$ 1,282	$ 1,118

The following table summarizes stock-based compensation expense related to employee stock options, ESPP and restricted stock units under SFAS No. 123R for the nine-months ended September 30, 2007 and 2006, respectively, and were allocated as follows (in thousands):

	Nine-Months Ended September 30, 2007	Nine-Months Ended September 30, 2006
Subscriptions and support	$ 201	$ 176
Service	412	578
Cost of revenue	613	754
Research and development	435	382
Sales and marketing	798	783
General and administrative	1,577	1,209
Stock-based compensation expense included in operating expenses	2,810	2,374
Total stock-based compensation expense	$ 3,423	$ 3,128

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A summary of option activity under SumTotal Systems' stock equity plans during the nine-months ended September 30, 2007 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, 2006	6,300	$ 6.80	7.12	
Granted	1,254	7.25		
Exercised	(374)	5.35		
Cancelled	(410)	8.36		
Outstanding at September 30, 2007	6,770	$ 6.87	6.97	$ 4,490
Exercisable at September 30, 2007	4,300	$ 7.17	5.86	$ 3,683

A summary of the status of the changes in SumTotal Systems' restricted stock units during the nine-months ended September 30, 2007 is as follows:

	Number of Shares (in thousands)	Quoted Market Price of Common Stock on Grant Date
Non-vested restricted shares at December 31, 2006	75	$ 4.30
Granted	—	—
Vested	(25)	4.30
Cancelled	—	—
Non-vested restricted shares at September 30, 2007	50	$ 4.30

The following table summarizes significant ranges of outstanding and exercisable options as of September 30, 2007:

	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	1,132	5.96	$ 3.38	1,081	$ 3.34
$4.39 - $ 4.65	1,036	7.47	4.50	563	4.51
$4.67 - $ 6.65	1,387	7.92	5.90	681	5.76
$6.71 - $ 7.37	1,078	8.65	7.07	191	7.20
$7.43 - $ 7.62	1,092	5.54	7.61	1,068	7.62
$7.68 -$83.42	1,045	6.07	13.28	716	15.71
$1.07 -$83.42	6,770	6.97	$ 6.87	4,300	$ 7.17

The total intrinsic value of options exercised during the three and nine-months ended September 30, 2007 was approximately $59,000 and $909,000, respectively. The total intrinsic value of shares issued under the employee stock purchase plan during the three and nine-months ended September 30, 2007 was approximately $98,000 and $239,000, respectively. The fair value of options and restricted shares vested was approximately $921,000 and $2,926,000 for the three and nine-months ended September 30, 2007, respectively. As of September 30, 2007, total unrecognized compensation costs related to non-vested stock options was $10.9 million, which is expected to be recognized as expense over a weighted average period of approximately 2.7 years. The weighted average grant date fair value of options granted in the three and nine-months ended September 30, 2007 was $4.48 and $5.55, respectively.

Adoption of Other Accounting Standards

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 was adopted as of January 1, 2007 and did not have a material impact on SumTotal Systems' results of operations and financial condition.

In September 2006, the SEC issued SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* , which 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 was adopted as of January 1, 2007 and did not have a material impact on SumTotal Systems' results of operations and financial condition.

In June 2006, the FASB issued FIN No. 48, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on de-recognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. SumTotal Systems adopted FIN No. 48 effective January 1, 2007.

As a result of the implementation of FIN No. 48, SumTotal Systems recognized a $0.3 million increase in liability for unrecognized tax benefits, which was accounted for as a $0.2 million reduction to the January 1, 2007 balance of retained earnings and as a $0.1 million increase in deferred tax assets. SumTotal Systems has a liability for unrecognized tax benefits of approximately $0.3 million as of January 1, 2007, all of which if recognized would result in a reduction of SumTotal System's effective tax rate. SumTotal Systems recorded no increase to its liability for unrecognized tax benefits as of September 30, 2007. In accordance with FIN No. 48, SumTotal Systems has decided to classify interest and penalties related to income taxes as a component of income tax expense. Interest and penalties are immaterial at the date of adoption and are included in the unrecognized tax benefits. SumTotal Systems is subject to audit by various taxing authorities for open returns from 2000 through 2006.

Recent Accounting Pronouncements

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 which would be SumTotal Systems' fiscal year 2008 beginning January 1, 2008. SumTotal Systems is currently evaluating the impact of adopting SFAS No. 157 on its financial statements.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* . SFAS No. 159 provides that companies may elect to measure specified financial instruments and warranty and insurance contracts at fair value on a contract-by-contract basis, with changes in fair value recognized in earnings in each reporting period. The election, called the "fair value option" will enable some companies to reduce the variability in reported earnings caused by measuring related assets and liabilities differently. SFAS No. 159 is effective for SumTotal Systems' fiscal year 2008 beginning January 1, 2008 Management is currently evaluating whether SFAS No. 159 will have an impact on SumTotal Systems' results of operations and financial condition.

NOTE 3: ACQUISITIONS AND INTANGIBLE ASSETS

MindSolve Acquisition

On November 14, 2006, SumTotal Systems acquired MindSolve Technologies, Inc. ("MindSolve"), a leading provider of Performance Management products and services for the delivery and administration of performance appraisals, multi-source assessments, career and succession planning, goal tracking functions and accountability management.

The total purchase price was comprised of (in thousands):

Cash consideration for common stockholders	$ 2,615
Cash consideration for employees	427
Fair value of common stock issued (1)	6,432
Note payable to shareholder	1,261
Estimated acquisition related costs (2)	528
Total consideration	$11,263

(1) The stockholders of MindSolve received $2,615,000 in net cash consideration and 925,000 shares of SumTotal Systems' common stock. The fair value of SumTotal Systems' common shares issued is based on a per share value of $6.954, 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") Global Market for the trading-day period beginning two days before and ending two days after November 14, 2006, the date of announcement of the acquisition.

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

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The total purchase consideration was allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective fair values at the acquisition date and resulted in excess purchase consideration over the net tangible liabilities and identifiable intangible assets acquired of $6.2 million. The following condensed balance sheet data presents the estimated fair value of the assets and liabilities assumed (in thousands):

Assets acquired:	
Cash and cash equivalents	$ 123
Accounts receivable	936
Prepaid expenses and other assets	119
Equipment and leasehold improvements, net	150
In-process research and development	1,120
Goodwill	6,155
Intangible assets	4,450
Other assets	78
	13,131
Liabilities assumed:	
Accrued liabilities	(220)
Deferred revenue	(1,648)
	(1,868)
Total consideration	$11,263

Goodwill of $6.2 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. In addition, a portion of the purchase price was allocated to the following identifiable intangible assets (in thousands, except years):

	Allocated Purchase Price	Estimated Weighted Average Useful Lives in Years
Core and developed technologies	$ 2,190	3.00
Customer installed-base relationships	1,710	5.00
Customer backlog	550	3.00
Total intangible assets	$ 4,450	3.77

In connection with the MindSolve acquisition in November 2006, SumTotal Systems has two notes payable to a former MindSolve officer. Total future obligations amount to $1,438,000 and will be paid in two equal installments of $719,000 in November 2007 and 2008, respectively. In addition, effective with the MindSolve acquisition, SumTotal Systems has change of control payments to be made to certain employees of MindSolve who are now employees of SumTotal Systems. These contractual changes of control payments are being expensed ratably over the contractual performance period. Total future obligations amount to $1,508,000 with scheduled payments of $920,000 and $588,000 in 2007 and 2008, respectively.

The results of operations of MindSolve since November 14, 2006 are included in SumTotal Systems' statement of operations.

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NOTE 4: GOODWILL AND INTANGIBLE ASSETS

Goodwill and intangible assets at September 30, 2007 and December 31, 2006 are as follows (in thousands):

	September 30, 2007		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Goodwill	$ 68,461	$ —	$ 68,461
Intangible assets:			
Acquired technology	$ 13,312	$ (10,590)	$ 2,722
Customer installed-base relationships	17,094	(6,988)	10,106
Customer hosted relationships	1,014	(717)	297
Customer contract relationships	8,525	(6,675)	1,850
Non-compete covenant	980	(980)	—
Total intangible assets	$ 40,925	$ (25,950)	$ 14,975

	December 31, 2006		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Goodwill	$ 68,461	$ —	$ 68,461
Intangible assets:			
Acquired technology	$ 13,312	$ (8,827)	$ 4,485
Customer installed-base relationships	17,094	(4,418)	12,676
Customer hosted relationships	1,014	(565)	449
Customer contract relationships	8,525	(5,007)	3,518
Non-compete covenant	980	(781)	199
Total goodwill and intangible assets	$ 40,925	$ (19,598)	$ 21,327

There was no impairment of goodwill or intangible assets for the three and nine-months ended September 30, 2007 and 2006, respectively.

The following represents the expected future amortization of intangible assets as of September 30, 2007 (in thousands):

Remainder of 2007	$ 2,050
2008	5,840
2009	4,038
2010	1,841
2011	1,080
2012	126
Total expected future amortization of intangible assets	$14,975

Amortization expense related to intangible assets was approximately $2.1 million and $2.1 million in the three-months ended September 30, 2007 and 2006, respectively, and approximately $6.4 million and $6.6 million in the nine-months ended September 30, 2007 and 2006, respectively.

NOTE 5: BORROWINGS

The current portion of notes payable consists of the following (in thousands):

	September 30, 2007	December 31, 2006
Litigation settlement	$ 1,100	$ 1,054
MindSolve stockholder	712	666
Credit facility	4,375	4,375
Total current portion of notes payable	$ 6,187	$ 6,095

The non-current portion of notes payable consists of the following (in thousands):

	September 30, 2007	December 31, 2006
Litigation settlement	$ 566	$ 1,375
MindSolve stockholder	651	610
Credit facility	5,469	8,750
Total non-current portion of notes payable	$ 6,686	$ 10,735

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, Inc. (“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, as adjusted, to meet the working capital requirements of the business (the “Revolver”).

Prior to the amendment of the credit facility on June 19, 2007, outstanding loan balances would bear interest at Wells Fargo Foothill’s base rate plus 2%, unless SumTotal Systems elected to be charged at the London Interbank Offered Rate (“LIBOR”) rate plus 3.5%. On June 19, 2007, SumTotal Systems entered into an amendment of its credit facility in which, among other things, the determination of the interest rate was changed from the description above to a scalable schedule of the base rate, based on earnings before interest, taxes, depreciation and amortization (“EBITDA”). As of September 30, 2007, SumTotal Systems’ interest rate under the credit facility was a LIBOR rate of 5.36% plus 2.25%, resulting in a total interest rate of 7.61%. The Term Loan is due in principal 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 EBITDA, leverage ratios, as well as restrictions on capital expenditures, indebtedness, distributions, investments and on change of control. There is only monitoring and no enforcement of the financial covenants if SumTotal Systems 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, 2007, SumTotal Systems had $54.4 million, comprising $49.6 million in qualified cash accounts and $4.8 million in excess availability under the Revolver and therefore no test of the covenants was required. 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 $9.8 million at September 30, 2007.

In accordance with the terms of the Term Loan, during the three and nine-months ended September 30, 2007, SumTotal Systems made total payments of $1.3 million and $4.0 million, respectively, to Wells Fargo Foothill. Of these amounts, $1.1 million and $0.2 million were principal and interest, respectively, for the three-month period ended September 30, 2007 and $3.3 million and $0.7 million were principal and interest, respectively for the nine-month period ended September 30, 2007.

During July 2006, SumTotal Systems entered into an agreement with Wells Fargo Foothill in which SumTotal Systems will enter into forward foreign exchange contracts to mitigate certain foreign exchange exposures 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 Systems 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.

On September 26, 2007, SumTotal Systems entered into a forward contract in which SumTotal Systems sold approximately 2.5 million United Kingdom (“U.K.”) Pound Sterling (“GBP”), equivalent $5.0 million U.S. Dollars (“USD”), for a value date of October 31, 2007, for which a hypothetical 10% appreciation of the GBP to USD would result in a $0.6 million gain and a hypothetical 10% depreciation of GBP to USD would result in a $0.4 million loss.

The effect of foreign exchange rate fluctuations for the three and nine-months ended September 30, 2007, was a cumulative net loss of $7,000 and a cumulative net loss of $51,000, respectively, as compared to a cumulative net loss of $48,000 and to a cumulative net gain of $125,000 in the corresponding prior year periods. Due to the substantial volatility of currency exchange rates, among other factors, SumTotal Systems cannot predict the effect of exchange rate fluctuations on its future operating results.

Litigation Settlement

On March 14, 2006, SumTotal Systems entered into an agreement to settle all patent infringement claims with IpLearn 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 valued at $181,000. The settlement was reached with no admission of liability or wrongdoing by any party. The aggregate amount of the settlement was accrued as of December 31, 2005. The remaining liability is included in notes payable on the accompanying unaudited Condensed Consolidated Balance Sheet at September 30, 2007 and totaled $1.7 million, of which $1.1 million and $0.6 million is classified as current and non-current, respectively.

MindSolve Stockholder

In connection with the MindSolve acquisition in November 2006, SumTotal Systems has two notes payable to a former MindSolve stockholder. Refer to Note 3, *Acquisitions and Intangible Assets* and Note 7, *Commitments and Contingencies,* for a further discussion of the MindSolve acquisition.

NOTE 6: RESTRUCTURING

The following table depicts restructuring activity for the nine-months ended September 30, 2007 (in thousands):

	Balance at December 31, 2006	Cash Expenditures	Balance at September 30, 2007
Vacated facilities	$ 714	$ (703)	$ 11
Employee severance	48	(48)	—
Other	113	(94)	19
Total restructuring activity	$ 875	$ (845)	$ 30

Obligations for restructured facility leases were accrued on the consolidated balance sheet at their net present values including estimated future sublease rentals based on current market expectations.

NOTE 7: COMMITMENTS AND CONTINGENCIES

Commitments

SumTotal Systems leases office space and certain equipment under non-cancelable operating leases expiring in years through 2015. Rent expense under operating leases was approximately $705,000 and $624,000 during the three-months ended September 30, 2007 and 2006, respectively, and $2,045,000 and $1,993,000 during the nine-months ended September 30, 2007 and 2006, respectively.

Future payments under operating lease obligations at September 30, 2007 are presented in the table below (in thousands):

	Payments Due by Period						
	Total	Remainder of 2007	2008	2009	2010	2011	Thereafter
Operating leases	$5,965	$ 706	$2,532	$1,264	$507	$255	$ 701

In connection with the MindSolve acquisition in November 2006, SumTotal Systems has two notes payable to a former MindSolve officer. Total future obligations amount to $1,438,000 and will be paid in two equal installments of $719,000 in November 2007 and 2008, respectively. In addition, effective with the MindSolve acquisition, SumTotal Systems has change of control payments to be made to certain employees of MindSolve who are now employees of SumTotal Systems. These contractual change of control payments and are being expensed ratably over the contractual performance period. Total future obligations amount to $1,508,000 with scheduled payments of $920,000 and $588,000 in 2007 and 2008, respectively.

In October 2005, retention bonuses were granted to certain officers of SumTotal Systems. These bonuses were anticipated to be paid in two equal amounts in 2006 and 2007 except for a former officer of SumTotal whose retention bonus was all paid in January 2007. Assuming the remaining affected officers are still employed by SumTotal Systems through 2007, the remaining future payments of $843,000 will be paid in the fourth quarter of 2007. These retention bonuses are being expensed ratably over the performance period.

SumTotal Systems has entered into various arrangements with hosting services vendors expiring through 2007 totaling $714,000.

Contingencies

On August 16, 2006, the Compensation Committee approved and adopted a form of Amended and Restated Change of Control Agreement for each of SumTotal Systems' Section 16 officers. In the event of a change of control of SumTotal Systems and the subsequent termination of a Section 16 officer in a manner defined as a Termination Event, SumTotal Systems will be obligated to pay the Section 16 officer certain compensation and benefits. If a Termination Event occurs, an officer would be entitled to one year of the officer's base salary that would be paid in equal semi-monthly installments over a one year period following a Termination Event. Such officer will also be entitled to other benefits as described in Article III of the Amended and Restated Change of Control Agreement. This discussion is qualified in its entirety by the Current Report on Form 8-K filed by SumTotal Systems on August 17, 2006.

From time-to-time, third parties assert patent infringement claims against SumTotal Systems in the form of letters, litigation, or other forms of communication. In addition, from time-to-time, SumTotal Systems is subject to other legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights. Management does not believe that any of the foregoing claims are likely to have a material adverse effect on its financial position, results of operations or cash flows.

NOTE 8: GUARANTEES, WARRANTIES AND INDEMNIFICATION

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, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* 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

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 financial performance as a basis for business operating decisions. Therefore, SumTotal Systems has determined that it operates in a single reportable segment.

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

	Three-Months Ended September 30,			
	2007		2006	
	Revenue	Percent of Revenue	Revenue	Percent of Revenue
United States	$24,541	83.7%	$22,395	83.0%
Other Americas	959	3.3%	1,011	3.8%
Total Americas	25,500	87.0%	23,406	86.8%
Europe	3,065	10.5%	2,724	10.1%
Asia/Pacific	752	2.5%	824	3.1%
Total revenue	$29,317	100.0%	$26,954	100.0%

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	Nine-Months Ended September 30,			
	2007		2006	
	Revenue	Percent of Revenue	Revenue	Percent of Revenue
United States	$71,762	81.0%	$60,973	79.9%
Other Americas	3,976	4.5%	3,161	4.1%
Total Americas	75,738	85.5%	64,134	84.0%
Europe	9,536	10.8%	9,322	12.2%
Asia/Pacific	3,319	3.7%	2,904	3.8%
Total revenue	$88,593	100.0%	$76,360	100.0%

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, 2007	December 31, 2006
United States	$ 89,430	$ 94,344
Europe	333	384
India	2,260	2,063
Asia/Pacific	136	136
Total long-lived assets	$ 92,159	$ 96,927

NOTE 10: REGISTERED DIRECT OFFERING

On May 23, 2007, SumTotal Systems sold approximately $35.1 million of common stock in a registered direct offering to accredited institutional investors. SumTotal Systems incurred approximately $2.4 million of transaction fees and expenses associated with the offering. The shares were offered through a prospectus supplement pursuant to SumTotal Systems' effective $75.0 million shelf registration statement. The shelf registration statement, which was filed with the SEC and became effective in October 2006, allows SumTotal Systems to offer and sell an aggregate of $75.0 million in debt and equity securities, the terms of which will be established at the time of the offering by means of a written prospectus or prospectus supplement. The May transaction involved the sale of 5,407,571 shares of SumTotal Systems' common stock at a sale price of $6.50 per share. The common shares sold in this transaction, after giving effect for the weighted average period of time outstanding from the date of sale, are included in the computation of the basic and diluted net loss for the three and nine-month periods ended September 30, 2007, respectively. The net proceeds of the transaction will be used for general corporate purposes, to potentially repay or prepay debt and/or for investments and acquisitions.

NOTE 11: LEGAL PROCEEDINGS

From time-to-time, SumTotal Systems is involved in legal proceedings or threats of legal proceedings arising in the ordinary course of business. SumTotal Systems is 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 its business, operating results and financial condition.

NOTE 12: SUBSEQUENT EVENT

On October 30, 2007, SumTotal Systems' announced that it will be taking a restructuring charge in the fourth quarter of 2007 for a reduction in its workforce to reduce its cost structure. The restructuring charge is anticipated to be approximately $1.0 million; however there are presently no assurances as to the final amount.

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

Forward-Looking Statements

The following discussion and analysis should be read in conjunction with the unaudited Condensed Consolidated Financial Statements and related Notes contained elsewhere within this document. Operating results for the three-month and nine-month periods ended September 30, 2007 are not necessarily indicative of the results that may be expected for any future periods, including the full fiscal year. Reference should also be made to the Annual Consolidated Financial Statements, Notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors contained in the SumTotal Systems Annual Report on Form 10-K for the year ended December 31, 2006.

This Quarterly Report 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", "predict", "could", "will", "estimate" 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, capital expense and business expansion requirements for at least the next 12 months; 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, including future product launches; marketing statements; industry leadership; internal controls and procedures; statements about our new product, SumTotal 7 Series; revenue recognition; continued growth in our revenues from our professional service organization; effectiveness of our hedging programs; financial performance including, but not limited to, estimated revenues, operating expenses, gross margins, interest income and 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 "Risk Factors — 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.

Executive Summary

During the three and nine-months ended September 30, 2007, we continued to implement our growth strategy. Highlights with respect to operations include:

- further penetration into our customer base by selling additional licenses and modules;
- acquired new enterprise customers as enterprises increasingly standardize on one Learning Management System ("LMS") platform;
- continued our sales into the small and medium business ("SMB") market through our on-demand solutions;
- expanded our performance management customer base through new customers and selling into our existing customer base;
- released SumTotal Enterprise Suite™ 7.6 during the third quarter of 2007, which included a number of components of functionality based on customer feedback, the foremost which were ease of use and configurability; and
- continued the deployment of our products in a hosted or on-demand model which has enabled us to increase our subscription and support revenue, which includes on-demand and hosting subscriptions, term licenses and maintenance. This has grown from 45% and 46% of our revenue in the three and nine-month periods ended September 30, 2006 to 53% and 51% in corresponding periods in 2007. Typically, these are annual contracts, most of which are renewed at the expiration of their term.

During the second quarter of 2007, we completed our registered direct offering through a prospectus supplement pursuant to our effective shelf registration statement in which we sold 5,407,571 shares of our common stock at $6.50 per share for aggregate gross proceeds of $35.1 million. The net proceeds of approximately $32.7 million will be used for general corporate purposes and working capital requirements, to potentially repay or prepay our debt, and investments and acquisitions. The capital will strengthen our balance sheet and allow us to continue to grow within our core learning and performance management business.

During the third quarter, we issued a press release announcing that our Board of Directors authorized the repurchase of up to $15 million of our outstanding shares of common stock. Stock repurchases will be made in the open market, in block purchase transactions, or in structured SEC Rule 10b5-1 share repurchase plans, and may be made from time to time or in one or more larger repurchases. We intend to conduct the repurchase in compliance with SEC Rule 10b-18. The program does not obligate us to acquire any particular amount of common stock and the program may be modified, suspended or terminated at any time at our discretion.

Total revenue increased from $27.0 million and $76.4 million in three and nine-month periods ending September 30, 2006, respectively, to $29.3 million and $88.6 million in corresponding periods in 2007, and our cash flow from operating activities increased from $4.2 million in the first nine-months of 2006 to $11.1 million in the corresponding period in 2007. Our net loss decreased from $2.7 million and $9.4 million in the three and nine-months ended September 30, 2006, respectively, to $2.0 million and $5.3 million in the corresponding periods in 2007, primarily due to the increase in our subscriptions and support revenue. We believe that our subscriptions and support revenue will continue to increase as a percentage of our overall business.

Critical Accounting Policies and Estimates

In most cases, the accounting treatment of a particular transaction is specifically dictated by GAAP 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;
- goodwill and intangible assets;
- restructuring;
- allowance for deferred tax assets and income tax expense;
- business combinations; 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 accompanying Notes to the Unaudited Condensed Consolidated Financial Statements, which contain additional information regarding our accounting policies and other disclosures required by GAAP.

We have made no 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 16, 2007, other than to the income taxes policy discussed below.

As described in Note 2, *Summary of Significant Accounting Policies,* in the accompanying Notes to the unaudited Condensed Consolidated Financial Statements, our accounting policy for income taxes was recently modified due to the adoption of FIN No. 48 and is described below.

In June 2006, the FASB issued FIN No. 48, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on de-recognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. We adopted FIN No. 48 effective January 1, 2007. FIN No. 48 requires significant judgment in determining what constitutes an individual tax position as well as assessing the outcome of each tax position. Changes in judgment as to recognition or measurement of tax positions can materially affect the estimate of the effective tax rate and consequently, affect our operating results.

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Comparison of Financial Data for the Three and Nine-Months Ended September 30, 2007 and 2006

Results of Operations

The following table presents our results of operations as a percentage of total revenue for the three and nine-months ended September 30, 2007 and 2006:

	Three-Months Ended September 30,		Nine-Months Ended September 30,	
	2007	2006	2007	2006
Revenue:				
Subscriptions and support	53.4%	45.3%	51.1%	45.6%
Service	28.4	30.6	27.7	29.1
License	18.2	24.1	21.2	25.3
Total revenue	100.0	100.0	100.0	100.0
Cost of revenue:				
Subscriptions and support	18.4	14.2	17.3	14.3
Service	17.0	22.3	18.2	21.4
License	0.4	1.1	0.5	0.8
Amortization of intangible assets	7.0	7.8	7.2	8.6
Total cost of revenue	42.8	45.4	43.2	45.1
Gross margin	57.2	54.6	56.8	54.9
Operating expenses:				
Research and development	18.4	17.0	17.7	16.6
Sales and marketing	29.7	29.3	28.8	29.8
General and administrative	16.8	17.0	16.2	19.8
Restructuring	0.0	0.3	0.0	0.1
Total operating expenses	64.9	63.6	62.7	66.3
Loss from operations	(7.7)	(8.9)	(5.9)	(11.5)
Other income (expense), net	1.3	(1.1)	0.1	(0.8)
Loss before income taxes	(6.4)	(10.0)	(5.8)	(12.3)
Provision for income taxes	0.4	0.0	0.2	0.0
Net loss	(6.8)%	(10.0)%	(6.0)%	(12.3)%

Comparison of Financial Data for the Three-Months Ended September 30, 2007 and 2006

Revenue

Revenue for the three-months ended September 30, 2007 and 2006 was as follows (in thousands, except percentages):

	Three-Months Ended September 30,		Change in Dollars	Change in Percent
	2007	2006		
Subscriptions and support	$15,669	$12,222	3,447	28.2%
Percentage of net revenue	*53.5 %*	*45.3 %*		
Services	8,338	8,241	97	1.2%
Percentage of net revenue	*28.4 %*	*30.6 %*		
License	5,310	6,491	(1,181)	(18.2)%
Percentage of net revenue	*18.1 %*	*24.1 %*		
Total revenue	$29,317	$26,954	$ 2,363	8.8%

In the three-months ended September 30, 2007, we were successful in winning and completing installations of large enterprise-wide solutions and generating consulting revenue from existing customers upgrading their legacy systems to the SumTotal 7 Series. The increase in sales of our SumTotal 7 Series products and services to new and existing customers was approximately $1.4 million. Revenue from SumTotal Systems' sales of our acquired Performance Management product was approximately $1.2 million. Revenue from our acquired Pathlore customers decreased $0.2 million as our Pathlore customer base continued its migration to the SumTotal 7 Series.

Subscriptions and support revenue. The increase in subscriptions and support revenue in the three-months ended September 30, 2007 over the comparable period in 2006 was as follows (in thousands, except percentages):

	Three-Months Ended September 30,		Change in	Change in
	2007	2006	Dollars	Percent
Hosting subscriptions	$ 3,606	$ 2,952	$ 654	22.2%
Term license rental arrangements	1,558	677	881	130.1%
On-demand subscriptions	1,724	612	1,112	181.7%
Total subscriptions	6,888	4,241	2,647	62.4%
Support maintenance	8,781	7,981	800	10.0%
Total subscriptions and support revenue	$15,669	$12,222	$ 3,447	28.2%

Approximately $2.4 million of the increase in subscriptions and support revenue in the three-months ended September 30, 2007 over the comparable period in 2006 was the result of subscription and support contract sales to new and existing customers related to the SumTotal 7 Series product suite and partner products and $0.9 million of the increase was the result of our acquired MindSolve customers. Changes to the components of subscriptions and support revenue were as follows:

- the increase in hosting subscriptions revenue was primarily the result of $0.6 million in increased sales of hosting contracts to new and existing customers related to the SumTotal 7 Series;
- the increase in term license rental arrangements revenue was primarily the result of a $1.0 million increase in sales of term license contracts to new and existing customers related to the SumTotal 7 Series;
- the increase in on-demand subscriptions revenue was primarily the result of a $0.8 million increase in sales to new and acquired MindSolve customers and a $0.3 million increase in sales of on-demand subscriptions contracts to new and existing customers related to the SumTotal 7 Series; and
- the increase in support maintenance revenue was the result of $0.5 million from increased maintenance contract sales to new and existing customers related to the SumTotal 7 Series and $0.2 million from our acquired Pathlore customers.

Price changes in subscriptions and support revenue had no material effect on the three-months ended September 30, 2007 over the comparable period in 2006.

Service revenue. Service revenue was relatively unchanged in the three-months ended September 30, 2007 over the comparable period in 2006. There was a $0.3 million increase in consulting revenue from additional consulting contracts to new and existing customers related to the SumTotal 7 Series, offset by a decrease of $0.3 million in service revenue from our acquired Pathlore customers, as our customer-base continued its migration to the SumTotal 7 Series. In the three-months ended September 30, 2006, our Pathlore service revenue was primarily related to the completion of installations of the Pathlore products sold prior to the acquisition in October 2005.

Price changes in service revenue had no material effect on our results for the three-months ended September 30, 2007 over the comparable period in 2006.

License revenue. The decrease in term license rental revenue in the three-months ended September 30, 2007 over the comparable period in 2006 was primarily due to a $0.9 million decrease in sales of the SumTotal 7 Series and a $0.4 million decrease in license revenue from our acquired Pathlore customers as they migrated to the SumTotal 7 Series.

Price changes in license revenue had no material effect on our results for the three-months ended September 30, 2007 over the comparable period in 2006.

Geographic Region. We sell our product in three geographic regions: Americas; Europe; and Asia/Pacific. Net sales, which include product and service revenue, for each region are summarized in the following table (in thousands, except percentages):

	Three-Months Ended September 30, 2007	Three-Months Ended September 30, 2006	Change in Dollars	Change in Percent
United States	$24,541	$22,395	$ 2,146	9.6%
Percentage of net revenue	*83.7 %*	*83.1 %*		
Other Americas	959	1,011	(52)	(5.1)%
Percentage of net revenue	*3.3 %*	*3.7 %*		
Americas	25,500	23,406	2,094	8.9%
Percentage of net revenue	*87.0 %*	*86.8 %*		
Europe	3,065	2,724	341	12.5%
Percentage of net revenue	*10.5 %*	*10.1 %*		
Asia/Pacific	752	824	(72)	(8.7)%
Percentage of net revenue	*2.5 %*	*3.1 %*		
Total revenue	$29,317	$26,954	$ 2,363	8.8%

The increase in total revenue for the three-months ended September 30, 2007 over the comparable period in 2006 was primarily due to increased sales of our software products in the Americas for the reasons addressed in the preceding discussion regarding revenue. Revenue in Europe increased due to the benefits of a change in sales management and foreign currency issues relating to the strengthening of the GBP and the Euro as compared to the USD. Revenue in Asia/Pacific was slightly lower in the three-months ended September 30, 2007 over the comparable period in 2006 due to lower sales in the Pacific Rim.

Price changes had no material effect on our revenue in any region or revenue type in the three-months ended September 30, 2007 over the comparable period in 2006.

No customer accounted for greater than 10% of total revenue in the three-months ended September 30, 2007, nor 2006.

Cost of Revenue

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

	Three-Months Ended September 30, 2007	Three-Months Ended September 30, 2006	Variance In Dollars	Variance in Percent
Subscriptions and support	$ 5,383	$ 3,822	$ 1,561	40.8%
Percentage of total revenue	*18.4 %*	*14.2 %*		
Service	4,986	6,027	(1,041)	(17.3)%
Percentage of total revenue	*17.0 %*	*22.4 %*		
License	125	289	(164)	(56.7)%
Percentage of total revenue	*0.4 %*	*1.1 %*		
Amortization of intangible assets	2,051	2,090	(39)	(1.9)%
Percentage of total revenue	*7.0 %*	*7.8 %*		
Total cost of revenue	$12,545	$12,228	$ 317	2.6%

Cost of subscriptions and support. The increase in cost of subscriptions and support in the three-months ended September 30, 2007 over the comparable period in 2006 was primarily due to an increase of $0.6 million for employees of the former MindSolve organization, an increase of $0.4 million for employee related expenses for additional employees in the U.S. and India, an increase of $0.3 million in depreciation and amortization of equipment and software due to capital investment in support of our growing hosted revenue streams and software subscription and maintenance expenses related to the expanded user base and an increase of $0.2 million in other costs. We expect cost of subscriptions and support to continue to increase in 2007 to support our growing customer base.

Cost of services. The decrease in cost of services in the three-months ended September 30, 2007 over the comparable period in 2006 is primarily due to a combination of additional costs using more expensive outside consultants (as compared to SumTotal Systems' personnel) and cost overruns associated with consultants in 2006, and better utilization of SumTotal Systems' service personnel and consultants in 2007.

Cost of license. The decrease in cost of license in the three-months ended September 30, 2007 over the comparable period in 2006 is primarily due to a $0.2 million reduction in the use of third party licenses and content. We expect the cost of license to remain lower than 2006 levels during the remainder of 2007.

Amortization of intangible assets. The amortization of intangible assets remained flat in the three-months ended September 30, 2007 over the comparable period of 2006. Amortization of intangible assets from the MindSolve acquisition increased $0.3 million over the comparable pre-acquisition period in 2006, offsetting decreases of $0.1 million for certain Docent intangible assets which became fully amortized and $0.2 million for certain Pathlore intangible assets that decreased based on adjusted cash flow projections of the business versus projections made at acquisition.

Gross Margin

The following table is the summary of gross margin between license and amortization of intangible assets, and service and maintenance (in thousands, except percentages):

	Three-Months Ended September 30,	
	2007	**2006**
Gross margin		
Subscriptions and support	$10,286	$ 8,400
Percentage of subscriptions and support revenue	*65.6 %*	*68.7 %*
Services	3,352	2,214
Percentage of services revenue	*40.2 %*	*26.9 %*
License	5,185	6,202
Percentage of license revenue	*97.6 %*	*95.5 %*
Amortization of intangible assets	(2,051)	(2,090)
Percentage of license revenue	*(38.6)%*	*(32.2)%*
Total gross margin	$16,772	$14,726
Percentage of net revenue	*57.2 %*	*54.6 %*

Gross margin for subscriptions and support in the three-months ended September 30, 2007 decreased over the comparable period in 2006 primarily due to the lower overall margin of our Total Performance product acquired in November 2006 due to the investments in staff and support costs made to expand that business.

Gross margin for services in the three-months ended September 30, 2007 increased primarily due to a combination of additional costs using more expensive outside consultants (as compared to SumTotal Systems' personnel) and cost overruns associated with consultants in 2006, and better utilization of SumTotal Systems' service personnel and consultants in 2007.

Gross margin for license, exclusive of amortization of intangible assets in the three-months ended September 30, 2007 increased over the comparable period in 2006 primarily due to the reduced usage of third party licenses and content. Gross margin for license, inclusive of amortization of intangible assets decreased due to the decrease in license revenue and the decrease in amortization of intangibles as described above.

Operating Expenses

The following table is a summary of research and development, sales and marketing, general and administrative and restructuring charge expenses (in thousands, except percentages):

	Three-Months Ended September 30, 2007	Three-Months Ended September 30, 2006	Variance in Dollars	Variance in Percent
Research and development	$ 5,400	$ 4,572	$ 828	18.1%
Percentage of net revenue	*18.4 %*	*17.0 %*		
Sales and marketing	8,700	7,895	805	10.2%
Percentage of net revenue	*29.7 %*	*29.3 %*		
General and administrative	4,915	4,571	344	7.5%
Percentage of net revenue	*16.8 %*	*17.0 %*		
Restructuring charge	—	68	(68)	(100)%
Percentage of net revenue	—	*0.3 %*		
Total operating expenses	$ 19,015	$ 17,106	$ 1,909	11.2%
Percentage of net revenue	*64.9 %*	*63.5 %*		

Research and development . The increase in research and development expense in the three-months ended September 30, 2007 over the comparable period in 2006 was primarily due to $1.0 million in additional personnel related costs, including personnel added as a result of the acquisition of MindSolve and increased staffing in India, offsetting a $0.4 million decrease in consulting expense. Facility and equipment expense associated with additional personnel increased $0.2 million over the comparable period in 2006.

Sales and marketing . The increase in sales and marketing expense in the three-months ended September 30, 2007 over the comparable period in 2006 was primarily due to increased salary costs from additional personnel, including personnel added as a result of the acquisition of MindSolve, and higher commissions due to the increased revenue level. Marketing programs expense decreased $0.1 million over the comparable period in 2006. Travel expense increased $0.1 million due to additional personnel over the comparable period in 2006. The remaining increase of $0.2 million was related to additional consulting expenses and other miscellaneous expenses.

General and administrative . The increase in general and administrative expense in the three-months ended September 30, 2007 over the comparable period in 2006 was primarily due to a $0.4 million increase in expenses related to general and administrative personnel and a $0.2 million increase in stock-based compensation expense, offsetting a $0.1 million decrease in accounting, legal and consulting fees associated with Sarbanes-Oxley Section 404 compliance and a $0.2 million decrease related to miscellaneous and other expenses.

Restructuring charge. The restructuring charge in the three-months ended September 30, 2006 was due to a restructuring accrual adjustment as result of a final lease termination agreement for our Chicago facility in the third quarter of 2006.

Non-Operating Expenses, Net

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

	Three-Months Ended September 30, 2007	Three-Months Ended September 30, 2006	Variance in Dollars	Variance in Percent
Interest expense	$ (304)	$ (429)	$ 125	(29.1)%
Percentage of net revenue	*(1.0)%*	*(1.6)%*		
Interest income	683	180	503	279.4%
Percentage of net revenue	*2.3 %*	*0.7 %*		
Other expense, net	(13)	(49)	36	(73.5)%
Percentage of net revenue	*(0.1)%*	*(0.2)%*		
Total non-operating expenses	$ 366	$ (298)	$ 664	(222.8)%
Percentage of net revenue	*1.2 %*	*(1.1)%*		

Interest expense . The decrease in interest expense in the three-months ended September 30, 2007 over the comparable period in 2006 was attributable to a lower principal balance and interest rates on the credit facility added in the fourth quarter of 2005 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 and interest rates.

Interest income . The increase in interest income in the three-months ended September 30, 2007 over the comparable period in 2006 was due to higher cash balances as a result of our registered direct offering in the second quarter.

Other expense, net . The decrease in other expense, net in the three-months ended September 30, 2007 over the comparable period in 2006 was primarily due to a reduction in net foreign exchange loss. In the third quarter of 2006, we adopted a forward exchange hedging program for the USD and GBP contracts which we believe will minimize future fluctuations related to changes in exchange rates.

Comparison of Financial Data for the Nine-Months Ended September 30, 2007 and 2006

Revenue

Revenue for the nine-months ended September 30, 2007 and 2006 was as follows (in thousands, except percentages):

	Nine-Months Ended September 30,		Change in	Change in
	2007	2006	Dollars	Percent
Subscriptions and support	$45,241	$34,858	$10,383	29.8%
Percentage of net revenue	*51.1 %*	*45.6 %*		
Services	24,550	22,185	2,365	10.7%
Percentage of net revenue	*27.7 %*	*29.1 %*		
License	18,802	19,317	(515)	(2.7)%
Percentage of net revenue	*21.2 %*	*25.3 %*		
Total revenue	$88,593	$76,360	$12,233	16.0%

In the nine-months ended September 30, 2007, we continued our success in winning and completing installations of large enterprise-wide solutions and generating consulting revenue from existing customers upgrading their legacy systems to the SumTotal 7 Series. The increase in sales of our SumTotal 7 Series products and services to new and existing customers was approximately $10.0 million. Revenue from SumTotal Systems' sales of our acquired Performance Management product was approximately $2.6 million. Revenue from our acquired Pathlore customers decreased $0.4 million as our Pathlore customer base continued its migration to the SumTotal 7 Series.

Subscriptions and support revenue. The increase in subscriptions and support revenue in the nine-months ended September 30, 2007 over the comparable period in 2006 was as follows (in thousands, except percentages):

	Nine-Months Ended September 30,		Change in	Change in
	2007	2006	Dollars	Percent
Hosting subscriptions	$ 10,878	$ 8,384	$ 2,494	29.7%
Term license rental arrangements	3,906	2,696	1,210	44.9%
On-demand subscriptions	4,368	1,357	3,011	221.9%
Total subscriptions	19,152	12,437	6,715	54.0%
Support maintenance	26,089	22,421	3,668	16.4%
Total subscriptions and support revenue	$ 45,241	$ 34,858	$10,383	29.8%

Approximately $6.5 million of the increase in subscriptions and support revenue in the nine-months ended September 30, 2007 over the comparable period in 2006 was the result of subscription and support contract sales to new and existing customers related to the SumTotal 7 Series product suite and partner products, $2.3 million of the increase was the result of our acquired MindSolve customers and $1.6 million of the increase was primarily the result of our former Pathlore customers renewing contracts at full value versus the acquired discounted fair value.

Changes to the components of subscriptions and support revenue were as follows:

- the increase in hosting subscriptions revenue was the result of 2.3 million in increased sales of hosting contracts to new and existing customers related to the SumTotal 7 Series and $0.2 million from increased sales to our acquired Pathlore customers;

- the increase in term license rental arrangements revenue was the result of a $1.7 million increase in contract sales to new and existing customers related to the SumTotal 7 Series, offsetting a $0.5 million decrease in term license arrangements revenue from our acquired Pathlore customers;
- the increase in on-demand subscriptions revenue was the result of $1.0 million from increased sales of our partner's performance management product and $2.0 million from increased sales to new and acquired MindSolve customers; and
- the increase in support maintenance revenue was the result of $1.5 million from increased maintenance contract sales to new and existing customers related to the SumTotal 7 Series, $1.9 million from acquired Pathlore customers renewing maintenance contracts at full value versus the deferred revenue that we acquired from Pathlore which was written down on the acquisition date in accordance with acquisition accounting principles and which was recognized in the 2006 period and $0.2 million from new and acquired MindSolve customers.

Price changes in subscriptions and support revenue had no material effect on the nine-months ended September 30, 2007 over the comparable period in 2006.

Service revenue. The increase in service revenue in the nine-months ended September 30, 2007 over the comparable period in 2006 was primarily due to a $3.9 million increase in consulting revenue from additional consulting contracts to new and existing customers related to the SumTotal 7 Series and a $0.1 increase from additional consulting contracts to new and existing MindSolve customers, offsetting a decrease of $1.6 million in service revenue from our acquired Pathlore customers due to decreased Pathlore license sales and associated service contracts as our customer-base continued its migration to the SumTotal 7 Series. In the nine-months ended September 30, 2006, our Pathlore service revenue was primarily related to the completion of installations of the Pathlore products sold prior to the acquisition in October 2005.

Price changes in service revenue had no material effect on our results for the nine-months ended September 30, 2007 over the comparable period in 2006.

License revenue. The increase in license revenue in the nine-months ended September 30, 2007 over the comparable period in 2006 was primarily due to a $0.9 million increase in sales of the SumTotal 7 Series and an increase of $0.1 million in license revenue from new Performance Management customers, offsetting a decrease of $1.5 million in license revenue from our acquired Pathlore customers as they migrated to the SumTotal 7 Series.

Price changes in license revenue had no material effect on our results for the nine-months ended September 30, 2007 over the comparable period in 2006.

Geographic Region. We sell our product in three geographic regions: Americas; Europe; and Asia/Pacific. Net sales, which include product and service revenue, for each region are summarized in the following table (in thousands, except percentages):

	Nine-Months Ended September 30,		Change in	Change in
	2007	2006	Dollars	Percent
United States	$ 71,762	$ 60,973	$10,789	17.7%
Percentage of net revenue	*81.0 %*	*79.8 %*		
Other Americas	3,976	3,161	815	25.8%
Percentage of net revenue	*4.5 %*	*4.1 %*		
Americas	75,738	64,134	11,604	18.1%
Percentage of net revenue	*85.5 %*	*84.0 %*		
Europe	9,536	9,322	214	2.3%
Percentage of net revenue	*10.8 %*	*12.2 %*		
Asia/Pacific	3,319	2,904	415	14.3%
Percentage of net revenue	*3.7 %*	*3.8 %*		
Total revenue	$ 88,593	$ 76,360	$12,233	16.0%

The increase in total revenue for the nine-months ended September 30, 2007 over the comparable period in 2006 was primarily due to increased sales of our software products in the Americas and for the reasons addressed in the preceding discussion regarding revenue. Revenue in Europe increased due to the benefits of a change in sales management and foreign currency issues relating to the strengthening of the GBP and the Euro as compared to the USD. Revenue in Asia/Pacific increased primarily due to increased sales of our software products throughout the Pacific Rim.

Price changes had no material effect on our revenue in any region or revenue type in the nine-months ended September 30, 2007 over the comparable period in 2006.

No customer accounted for greater than 10% of total revenue in the nine-months ended September 30, 2007, nor 2006.

Cost of Revenue

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

	Nine-Months Ended September 30,		Variance In	Variance in
	2007	2006	Dollars	Percent
Subscriptions and support	$ 15,295	$ 10,934	$ 4,361	39.9%
Percentage of total revenue	*17.3 %*	*14.3 %*		
Service	16,212	16,326	(114)	(0.7)%
Percentage of total revenue	*18.3 %*	*21.4 %*		
License	417	632	(215)	(34.0)%
Percentage of total revenue	*0.5 %*	*0.8 %*		
Amortization of intangible assets	6,352	6,586	(234)	(3.6)%
Percentage of total revenue	*7.2 %*	*8.6 %*		
Total cost of revenue	$ 38,276	$ 34,478	$ 3,798	11.0%

Cost of subscriptions and support. The increase in cost of subscriptions and support in the nine-months ended September 30, 2007 over the comparable period in 2006 was primarily due to $1.6 million of additional expenses for the acquired MindSolve organization, a $1.1 million increase for an additional employees in the U.S. and India, a $0.9 million increase in equipment and software costs resulting from capital investment in support of our growing hosted revenue streams and software subscription and maintenance expenses related to the expanded user base, and a $0.9 million increase in other costs. We expect cost of subscriptions and support to continue to increase in 2007 to support our growing customer base.

Cost of services. Cost of services in the nine-months ended September 30, 2007 over the comparable period in 2006 is relatively unchanged and reflects the net additional deferral of $1.0 million of services expenses related to the customization and implementation of our products. Expenses related to service personnel increased $1.0 million in the nine-months ended September 30, 2007 over the comparable period in 2006 with additional employees in the U.S. and Europe, offsetting a staff decrease in India. Travel expenses increased $0.5 million in 2007 over 2006 due primarily to travel billable to customers and a worldwide services training forum. Other expenses decreased $0.6 million in 2007 over the comparable period in 2006.

Cost of license. The decrease in cost of services in the nine-months ended September 30, 2007 over the comparable period in 2006 is due to reduced usage of third party licenses and content. We expect the cost of license to remain lower than 2006 levels during the remainder of 2007.

Amortization of intangible assets. The decrease in amortization of intangible assets in the nine-months ended September 30, 2007 over the comparable period of 2006 primarily due to a $0.5 million decrease in the amortization of certain Docent intangible assets in which became fully amortized in 2007 and a $0.6 million decrease in the amortization of Pathlore intangibles based on adjusted cash flow projections of the business compared to projections made at acquisition, offsetting a $0.9 million increase in amortization of intangible assets related to the MindSolve acquisition over the comparable pre-acquisition period in 2006.

Gross Margin

The following table is the summary of gross margin between license and amortization of intangible assets, and service and maintenance (in thousands, except percentages):

	Nine-Months Ended September 30, 2007	Nine-Months Ended September 30, 2006
Gross margin:		
Subscriptions and support	$ 29,946	$ 23,924
Percentage of subscriptions and support revenue	66.2%	68.6%
Services	8,338	5,859
Percentage of services revenue	34.0%	26.4%
License	18,385	18,685
Percentage of license revenue	97.8%	96.7%
Amortization of intangible assets	(6,352)	(6,586)
Percentage of license revenue	(33.8)%	(34.1)%
Total gross margin	$ 50,317	$ 41,882
Percentage of net revenue	56.8%	54.8%

Gross margin for subscriptions and support in the nine-months ended September 30, 2007 decreased over the comparable period in 2006 primarily due to the lower overall margin of our Total Performance product acquired in November 2006 due to the investments in staff and support costs made to expand that business.

Gross margin for services in the nine-months ended September 30, 2007 increased primarily due to service costs for the nine-months ended September 30, 2007 remaining relatively constant to the comparable period in 2006 on an increase in service revenue of $2.4 million,

Gross margin for license, exclusive of amortization of intangible assets in the nine-months ended September 30, 2007, improved slightly over the comparable period in 2006, attributable to the reduced usage of third party licenses and content. Gross margin for license, inclusive of amortization of intangible assets improved to due to the decline in license revenue from the prior year and the decrease in amortization of intangibles as described above.

Operating Expenses

The following table is a summary of research and development, sales and marketing, general and administrative and restructuring charge expenses (in thousands, except percentages):

	Nine-Months Ended September 30, 2007	Nine-Months Ended September 30, 2006	Variance in Dollars	Variance in Percent
Research and development	$ 15,697	$ 12,711	$ 2,986	23.5%
Percentage of net revenue	*17.7 %*	*16.6 %*		
Sales and marketing	25,557	22,760	2,797	12.3%
Percentage of net revenue	*28.8 %*	*29.8 %*		
General and administrative	14,335	15,123	(788)	(5.2)%
Percentage of net revenue	*16.2 %*	*19.8 %*		
Restructuring charge	—	68	(68)	(100)%
Percentage of net revenue	—	*0.1 %*		
Total operating expenses	$ 55,589	$ 50,662	$ 4,927	9.7%
Percentage of net revenue	*62.7 %*	*66.3 %*		

Research and development. The increase in research and development expenses in the nine-months ended September 30, 2007 over the comparable period in 2006 was primarily due to $2.1 million in additional employee and related costs associated with additional personnel, including hiring related to the acquisition of MindSolve and increased staffing in India, $0.8 million in additional facility and equipment expenses and $0.1 million in increased travel and recruitment expenses for additional staff.

Sales and marketing . The increase in sales and marketing expense in the nine-months ended September 30, 2007 over the comparable period in 2006 was primarily due to an increase of $1.7 million in salary costs from additional personnel, including personnel added as a result of the acquisition of MindSolve and higher commissions due to higher revenue levels, a $0.2 million increase in travel expense associated with increase staff, a $0.2 million increase in staff recruitment expenses and other miscellaneous expenses, offsetting a decrease of $0.1 million in marketing programs.

General and administrative . The decrease in general and administrative expense in the nine-months ended September 30, 2007 over the comparable period in 2006 was due to a $0.9 million decrease in accounting, legal and consulting fees associated with Sarbanes-Oxley Section 404 compliance and a $0.5 million decrease related to facility and other expenses, offsetting a $0.2 million increase in expenses relating to general and administrative personnel and a $0.4 million increase in stock-based compensation expense.

Restructuring charge. The restructuring charge in the nine-months ended September 30, 2006 was due to a restructuring accrual adjustment as result of a final lease termination agreement for our Chicago facility in the third quarter of 2006.

Non-Operating Expenses, Net

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

	Nine-Months Ended September 30,		Variance	Variance
	2007	2006	in Dollars	in Percent
Interest expense	$ (1,047)	$ (1,295)	$ 248	(19.2)%
Percentage of net revenue	*(1.2)%*	*(1.7)%*		
Interest income	1,224	532	692	130.1%
Percentage of net revenue	*1.4 %*	*0.7 %*		
Other expense, net	(56)	131	(187)	(142.7)%
Percentage of net revenue	*(0.1)%*	*0.2 %*		
Total non-operating expenses	$ 121	$ (632)	$ 753	(119.1)%
Percentage of net revenue	*0.1 %*	*(0.8)%*		

Interest expense . The decrease in interest expense in the nine-months ended September 30, 2007 over the comparable period in 2006 was attributable to a lower principal balance and interest rates on the credit facility added in the fourth quarter of 2005 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 and interest rates.

Interest income . The increase in interest income in the nine-months ended September 30, 2007 over the comparable period in 2006 was due to higher cash balances as a result of our registered direct offering in the second quarter.

Other income (expense), net . In the nine-months ended September 30, 2007, we experienced a net foreign exchange loss as opposed to a net foreign exchange gain in the prior comparable period. In third quarter of 2006, we adopted a forward exchange hedging program for the USD and GBP contracts which we believe will minimize future fluctuations related to changes in exchange rates.

Liquidity and Capital Resources

At September 30, 2007, our principal sources of liquidity were $29.5 million of cash and cash equivalents and $22.3 million of short-term investments and a revolving credit facility with Wells Fargo Foothill to a maximum of $5.0 million, adjusted as described in the following paragraph, to meet the working capital requirements of the business.

In July 2006, under our Revolver with Wells Fargo Foothill, we entered into an agreement with Wells Fargo Foothill in which we will enter into forward foreign exchange contracts to mitigate certain foreign exchange exposures we have 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, we have $250,000 less in funds available for use from the Revolver including debt covenant compliance and, accordingly, only $4,750,000 was available for borrowings at September 30, 2007.

On June 1, 2006, we filed a universal shelf registration statement on Form S-3 with the SEC which was declared effective October 2, 2006. Our shelf registration statement allows us to offer and sell an aggregate of $75.0 million in debt and equity securities, the terms of which will be established at the time of the offering by means of a written prospectus or prospectus supplement.

On May 23, 2007, we completed the sale of approximately $35.1 million of our common stock in a registered direct offering, in which approximately 5.4 million shares were sold at a purchase price of $6.50 per share through a prospectus supplement to our shelf registration statement. The shares were sold to accredited institutional investors with RBC Capital

Markets Corporation acting as sole placement agent for the transaction. The net proceeds raised from the offering provide us with greater working capital and will be used for general corporate purposes, to potentially repay or prepay our debt, and/or investments and acquisitions. As of September 30, 2007, there was approximately $39.9 million in debt and equity securities remaining eligible to be sold through the shelf registration statement.

On August 20, 2007, we issued a press release announcing that our Board of Directors authorized the repurchase up to $15 million of our outstanding shares of common stock. Stock repurchases will be made in the open market, in block purchase transactions, or in structured Rule 10b5-1 share repurchase plans, and may be made from time to time or in one or more larger repurchases. We intend to conduct the repurchase in compliance with the Securities and Exchange Commission's Rule 10b-18. The program does not obligate us to acquire any particular amount of common stock and the program may be modified, suspended or terminated at any time at our discretion.

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 year. We have borrowing capacity available to us in the form of our credit facility with Wells Fargo Foothill that expires in 2009. We may also consider raising additional capital in the public markets as a means to meet our capital needs and to invest in our business. Our future liquidity and capital requirements will depend on numerous factors, including our future revenue, 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. Although we may need to return to the capital markets, establish new credit facilities, or raise capital in private transactions in order to meet our capital requirements, we can offer no assurances that we will be able to access these potential sources of funds on terms acceptable to us, or at all.

Net cash provided by operating activities was $11.1 million during the nine-months ended September 30, 2007. The cash provided during the period primarily relates to collections of our trade receivables from our increased revenue in the fourth quarter of 2006 and the advance of funds from a major retail customer in the second quarter of 2007 as noted by a net decrease in accounts receivable of $6.0 million and a net increase in deferred revenue of $4.0 million, respectively. Offsetting these increases in operating cash are decreases in accrued compensation and benefits of $1.4 million, other accrued liabilities of $1.1 million and restructuring accrual of $0.8 million. Also included are adjustments to net loss for non-cash items which included intangible assets amortization of $6.4 million, stock-based compensation of $3.4 million and depreciation and amortization of 2.9 million.

Net cash used by investing activities was $20.9 million during the nine-months ended September 30, 2007. Purchases of property and equipment in the nine-months ended September 30, 2007 totaled $4.4 million and were primarily associated with increased staffing levels in our U.S. and India offices and additional leasehold improvements for expanding our facility in Hyderabad, India, and increased investment in our hosting equipment infrastructure. In addition, we purchased $27.6 million of short-term investments and had short-term investments maturities of $11.1 million of in the nine-months ended September 30, 2007. Short-term investments have increased primarily as a result of proceeds from the offering described above. As of September 30, 2007, short-term investments had a carrying value of $22.3 million.

Net cash provided by financing activities was $29.3 million in the nine-months ended September 30, 2007, and consisted of net proceeds from the offering described above of $32.7 million and $2.9 million in net proceeds from the issuance of common stock through our employee stock purchase plan and exercises of common stock options. Offset sources of financing are repayments of indebtedness under the Wells Fargo Foothill credit facility of $3.3 million, payments of $0.9 million under notes payable for Litigation Settlement and $2.1 million for purchases of treasury stock. Refer to Part II—Other Information—Item 2 **.** Unregistered Sales of Equity Securities and Use of Proceeds.

Commitments

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. For terms and details of the credit facility, including the requirement that we maintain certain restrictive covenants, refer to Note 5, *Borrowin* gs, in the accompanying Notes to the unaudited Condensed Consolidated Financial Statements .

We lease office space and certain equipment under non-cancelable operating leases expiring in years through 2015. Rent expense under operating leases was approximately $705,000 and $624,000 during the three-months ended September 30, 2007 and 2006, respectively, and $2,045,000 and $1,993,000 during the nine-months ended September 30, 2007 and 2006, respectively.

Future payments under operating lease obligations at September 30, 2007 are presented in the table below (in thousands):

	Payments Due by Period						
	Total	Remainder of 2007	2008	2009	2010	2011	Thereafter
Operating leases	$5,965	$ 706	$2,532	$1,264	$507	$255	$ 701

In connection with the MindSolve acquisition in November 2006, we have two notes payable to a former MindSolve officer. Total future obligations amount to $1,438,000 and will be paid in two equal installments of $719,000 in November 2007 and 2008, respectively. In addition, effective with the MindSolve acquisition, we have change of control payments to be made to certain employees of MindSolve who are now our employees. These contractual change of control payments and are being expensed ratably over the contractual performance period. Total future obligations amount to $1,508,000 with scheduled payments of $920,000 and $588,000 in 2007 and 2008, respectively.

In October 2005, retention bonuses were granted to certain officers of SumTotal Systems. These bonuses were anticipated to be paid in two equal amounts in 2006 and 2007 except for a former officer of SumTotal Systems whose retention bonus was all paid in January 2007. Assuming the remaining affected officers are still employed by SumTotal Systems thru 2007, the future payments of $843,000 will be paid in the fourth quarter of 2007. These retention bonuses are being expensed ratably over the performance period.

We have entered into various arrangements with hosting services vendors expiring through 2007 totaling $714,000.

Contingencies

On August 16, 2006, our Compensation Committee approved and adopted a form of Amended and Restated Change of Control Agreement for each of our Section 16 officers. In the event of a change of control of SumTotal Systems and the subsequent termination of a Section 16 officer in a manner defined as a Termination Event, we will be obligated to pay the Section 16 officer certain compensation and benefits. If a Termination Event occurs, an officer would be entitled to one year of the officer's base salary that would be paid in equal semi-monthly installments over a one year period following a Termination Event. Such officer will also be entitled to other benefits as described in Article III of the Amended and Restated Change of Control Agreement. This discussion is qualified in its entirety by the Current Report on Form 8-K filed by us on August 17, 2006.

From time-to-time, third parties assert patent infringement claims against us in the forms of letters, litigation, or other forms of communication. In addition, from time-to-time, we are subject to other legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights. We do not believe that any of the foregoing claims are likely to have a material adverse effect on our financial position, results of operations or cash flows. However, our analysis of whether a claim may proceed to litigation cannot be predicted with certainty, nor can the results of litigation be predicted with certainty. Defending each of these actions, regardless of the outcome, may be costly, time-consuming, distract management personnel and have a negative effect on our business. An adverse outcome in any of these actions, including a judgment or settlement, may cause a material adverse effect on our future business, operating results and/or financial condition.

Employee Stock Options

Our stock option program is a key component of the compensation package we provide to attract and retain talented employees and believe stock options provide our employees a strong link to our long term performance and the interests of our stockholders. The trading price of our common stock has been and is likely to continue to be highly volatile. As a result of this volatility, the trading price of our common stock may exceed the exercise price of options held by some of our employees and the effectiveness of our stock option program may be adversely impacted. For example, at September 30, 2007, 62% of our outstanding stock options had exercise prices in excess of the current market price of our common stock.

Recent Accounting Pronouncements

Refer to the discussion of recent accounting pronouncements in Note 2, *Summary of Significant Accounting Policies,* in the accompanying Notes to the 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, 2007, the fair value of cash and cash equivalents and short-term investments would not change by a material amount.

Prior to the amendment of the credit facility on June 19, 2007, outstanding loan balances would bear interest at Wells Fargo Foothill's base rate plus 2%, unless SumTotal Systems elected to be charged at LIBOR rate plus 3.5%. On June 19, 2007, SumTotal Systems entered into an amendment of its credit facility in which, among other things, the determination of the interest rate was changed from the description above to a scalable schedule of the base rate, based on EBITDA. As of September 30, 2007, SumTotal Systems' interest rate under the credit facility was a LIBOR rate of 5.36% plus 2.25%, resulting in a total interest rate of 7.61%. 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.

Foreign currency exchange risk. We have foreign currency risk as a result of sales by our foreign subsidiaries denominated in currencies other than the U.S. dollar. In the three and nine-months ended September 30, 2007, international revenue from our foreign subsidiaries accounted for approximately 16% and 19% of total revenue, which is relatively unchanged from 17% and 20% in the comparable periods in 2006, respectively. For the years ended December 31, 2006, 2005, and 2004, these sales amounted to 16%, 25%, and 29%, respectively. 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 of 2006, we began entering into 30 day forward contracts for USD and GBP to hedge anticipated cash flows from our U.K. subsidiary.

On September 26, 2007, we entered into a forward contract in which we sold approximately 2.5 million GBP, equivalent $5.0 million USD, for a value date of October 31, 2007, for which a hypothetical 10% appreciation of the GBP to USD would result in a $0.6 million gain and a hypothetical 10% depreciation of GBP to USD would result in a $0.4 million loss.

The effect of foreign exchange rate fluctuations for the three and nine-months ended September 30, 2007, was a cumulative net loss of $7,000 and a cumulative net loss of $51,000, respectively, as compared to a cumulative net loss of $48,000 and to a cumulative net gain of $125,000 in the corresponding prior year periods. Due to the substantial volatility of currency exchange rates, among other factors, we cannot predict the effect of exchange rate fluctuations our future operating results.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures.

Our management, with the participation of our chief executive officer and our chief financial officer, evaluated the effectiveness 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 (the "Exchange Act")) as of the end of the period covered by this quarterly report on Form 10-Q.

A control system, no matter how well conceived and operated, can provide only reasonable assurance that the objectives of the control system are met. Our management, including our chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures or internal control over financial reporting will prevent all errors and fraud. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues within SumTotal Systems have been detected. These inherent limitations include the reality that judgments in decision-making can be incorrect, and that breakdowns can occur because of simple errors or mistakes. The design of any control system is also based, in part, upon certain assumptions about the

likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a control system, misstatements due to error or fraud may occur and not be detected.

Based upon their evaluation of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this quarterly report on Form 10-Q, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures are effective based on their evaluation of these controls and procedures required by paragraph (b) of Exchange Act Rules 13a-15 or 15d-15.

Changes in internal controls.

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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 report 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. These risks and uncertainties may not be the only ones facing us. Furthermore, new risks and uncertainties arise from time to time, and we cannot predict those events or how they may affect us. All forward-looking statements included in this document 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 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 learning management solutions, the SumTotal 7 Series, as well as our legacy products and related services, including without limitation, maintenance, services, on-demand subscriptions and hosting. We have not been GAAP profitable and we may not achieve GAAP profitability. If we fail to continue to generate adequate revenue from the SumTotal 7 Series and related services, we will continue to incur losses.

We are in the process of shifting our emphasis to a subscription and support revenue model by offering our products as on-demand subscriptions. We anticipate that our future financial performance and revenue growth will depend upon the acceptance and growth of our on-demand products. As a result, we are in the process of transitioning to support on-demand subscription products, which represents a significant departure from traditional software delivery strategies. The relatively short history and continued evolution of this business model makes our business operations and prospects difficult to evaluate. As we shift our focus to offering our products on-demand, we will likely incur a reduction in our traditional software license revenues, which may not be offset by our on-demand revenues. This transition may require more time and resources than we currently anticipate, which would adversely impact our financial results.

Furthermore, we recently announced we were taking actions to reduce our operating expenses, including the elimination of a number of positions, resulting in a one-time restructuring charge in the fourth quarter of 2007. While we believe the full benefit of the savings of these actions will commence in the first quarter of 2008, there can be no guarantee that these cost reductions will enable us to be profitable in 2008 or subsequent periods.

In addition, in the future, we expect to continue to incur additional non-cash expenses relating to purchased intangible assets that will contribute to our net losses. Further, starting with the first quarter of fiscal 2006, we were required to record as an expense, charges related to all current non-vested outstanding and future grants of stock options in our reported results from operations in accordance with SFAS No. 123R. This had the impact of increasing our reported expenses and our GAAP losses. We expect to incur additional GAAP 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 GAAP basis.

Our operating results may fluctuate significantly from quarter to quarter and year to year and are difficult to predict, 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 to continue in the future. Our operating results may be affected by a number of other factors, including, but not limited to:

- the size and timing of product orders and the timing and execution of professional services engagements for SumTotal 7 Series and the legacy products;
- the mix of revenue from products and services;
- our transition to offering our products as on-demand subscriptions and a subscriptions and support revenue model;

- our ability to meet customer project milestones;
- market acceptance of our products and services, especially SumTotal 7 Series and related services;
- our ability to complete fixed-price professional services engagements within budget, on time and to our customers' satisfaction;
- ongoing costs and efforts in connection with compliance with Sarbanes-Oxley Section 404;
- the timing of revenue and expense recognition;
- industry consolidation among both our competitors and our customers;
- recognition of impairment of existing assets; and
- our ability to 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 performance management and compensation management solutions, and the rapidly evolving nature of our market make prediction of future revenue and expenses difficult. Expense levels are based, in part, on expectations as to future revenue and are essentially 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. Failure to meet our forecasts would likely cause a decline in the price of our common stock.

Our sales cycles in our traditional perpetual license business line are lengthy, making the timing of sales difficult to predict and also requiring considerable resources and expense with no assurance that such sales will occur.

For our traditional perpetual license business line, the period between our initial contact with a potential customer and a customer's purchase of our products and services is lengthy and 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 for 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 a significant portion of our revenue, and our revenue growth would be harmed. Many of our potential customers are large organizations which generally take more time to make significant business decisions, and the formation and execution of even a relatively small number of large contracts with these large organizations may have a significant impact on our revenue. In addition, we must expend and allocate resources prior to completing a sales transaction, with no guarantee that such transaction will result in an actual sale. Furthermore, the lengthening of our sales cycles may create increased difficulties in negotiating such sales on terms favorable to us. This may result in a delay or failure to generate revenue from our sales efforts and may adversely affect our stock price.

Adverse economic conditions, including reduced information technology spending or increased unemployment may adversely impact our business.

Our business depends on the overall demand for learning management systems solutions, and on the economic health of our current and prospective customers. The purchase of our products is often discretionary and may involve a significant commitment of capital and other resources. To the extent that the budgets for technology spending are reduced, demand for our products will also decrease. Furthermore, the market for our products may be disproportionately affected by weakness in general economic conditions or the broader market for information technology. Moreover, if the unemployment rate increases materially and training and retention of employees becomes less critical, our existing and potential clients may no longer consider improvement of their learning management systems a priority. Weak economic conditions, or a reduction in information technology spending even if economic conditions remain stable, would likely adversely impact our business, operating results and financial condition in a number of ways, including longer sales cycles, lower prices for our products and services and reduced sales.

Any future acquisitions we make, or attempt to make, will need to be integrated into our business and require significant time and effort from our management team, which may disrupt our business and harm our operating results or financial condition.

We have made and may continue to make acquisitions of businesses and technologies to enhance our existing 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 file our Annual Report on Form 10-K for the fiscal year ended December 31, 2004 with the SEC on a timely basis. The acquisition of Pathlore in October 2005 and the related difficulty in integrating the financial controls and procedures resulted in a material control weakness to our accounting for business combinations in fiscal 2005 and contributed to our filing an extension to file our Annual Report on Form 10-K for the fiscal year ended December 31, 2005. Moreover, the integration of the products, product roadmap, and operations from the combination of Docent, Click2learn, Pathlore, MindSolve and any other company we may acquire 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.

We rely on partnerships, alliances and other relationships to conduct our business and expect to expand our reliance on such relationships in the future.

Our business relies on a variety of partnerships, alliances and other relationships, such as those with content partners, resellers, original equipment manufacturers, solution integrators, human resource outsourcers and technology partners, to develop, market and sell our products and solutions. As our business grows and evolves, through adding new products and solutions or possible third party or product acquisitions, we have relied, and in the future, we may rely more heavily, on these types of partnerships. As a result, we have had to, and may in the future, have to renegotiate or terminate existing relationships. There can be no assurance that we will be able to enter into new contracts, or amend or terminate our existing contracts on favorable terms, or at all. In addition, if we amend or terminate any of our contracts, our former partners may become our competitors in the future. These former partners may be unhappy with their new relationships, and may, as a result, commence litigation against us, regardless of the merits of such litigation. Litigation is expensive to defend, and even the threat of legal proceedings diverts resources, and management attention from operating our business and causes increases in our expense levels, all of which may negatively affect the price of our common stock.

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

Undetected product defects may require us to halt sales or shipments of our products, delay introduction of new products, or account for warranty claims.

Our products are highly technical and complex and have contained and may contain undetected errors, bugs, security vulnerabilities or defects, some of which may only be discovered after a product has been installed and used by customers. Our product offerings, both current and future, are complex and often contain undetected errors or bugs, despite internal and third party testing. New product offerings contain new features and functionality which result in a greater likelihood of errors, bugs, security vulnerabilities and frequently these 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 such defects in our product line that we believed would be considered serious by our customers before shipment to them, SumTotal 7 Series is not error-free and some customers have notified us that they consider some of the defects in the SumTotal 7 Series to be serious. In addition, our products include third party software, and any defects in third party software that we incorporate into our products may compromise our products. It may be difficult for us to determine the source of the problem and correct any errors in third party software because such software is not within our control.

Any bugs, errors, defects or security vulnerabilities discovered in our products after commercial release could result in loss of revenue or delay in revenue recognition, loss of customers and increased service and warranty costs, any of which could adversely affect our business, operating results and financial condition. In addition, we could face claims for product liability, tort or breach of warranty, including claims relating to changes to our products made by our channel partners. Our contracts with customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld. Defending a lawsuit, regardless of its merit, is costly and may divert management’s attention and adversely affect the market’s perception of us and our products. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms or at all, our business, operating results and financial condition could be adversely impacted.

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 limit contractually our liability for damages arising from defects and other mistakes in our software products and in rendering professional services, these contractual protections are not always available and may not be enforced or otherwise protect us from liability for claims such as warranty claims, refund claims, or litigation claims. If such a claim is successful, we may be required to refund money and our insurance may not be sufficient to cover our liability. 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.

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

We introduced SumTotal 7.0 in late December 2004, SumTotal 7.1 in April 2005, SumTotal 7.2 in June 2006, SumTotal 7.5 in December 2006, and SumTotal 7.6 in June 2007, and plan to launch subsequent product releases. 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 new upgrades. 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. In addition, our implementations may be very complicated and require more time and resources than originally forecasted. As a result, we may not be able to complete the requisite work necessary in order to gain customer acceptance, which may delay or prevent us from recognizing revenue on deals we have signed, but revenue has not yet been recognized. If we fail to successfully manage the transition to new product offerings, 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 7 Series, means that any decline in price or demand for our products and services would seriously harm our business.

We expect the SumTotal 7 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 7 Series and successor products or services, or their failure to achieve broad market acceptance, would seriously harm our business and would likely result in a decline in the price of our common stock.

The anticipated benefits of our acquisition of MindSolve may be delayed or may not be realized.

We expect that our acquisition of MindSolve will enhance our position in the performance management industry through the integration of MindSolve's technologies, products, services, partnerships, and customer contacts into our current product offerings. Achieving the expected benefits of the acquisition, however, depends in part on the integration of MindSolve's technology, products, operations, partnerships, and personnel in a timely and efficient manner. The challenges involved in successful integration include:

- incorporating MindSolve's technology and products into our offerings, business, and distribution channels;
- scaling the MindSolve business successfully without significant additional expense;
- integrating the MindSolve customer base, operations and financial reporting function into our operations and financial reporting systems;
- integrating the MindSolve technical team and sales organization into our larger and more widely dispersed engineering organization and sales organization; and
- selling and marketing into the stand-alone performance management market successfully.

Nevertheless, we may not realize all of the anticipated benefits associated with the acquisition in a timely manner or at all. For example, while we have integrated MindSolve's performance management solutions into our own services and products, this combined offering has not achieved the growth or market acceptance we had initially anticipated. If we are unable to generate greater growth and acceptance of the performance management offering, our business and financial results may be harmed.

Furthermore, the sale of MindSolve's products may not contribute to our results to the extent we expect for a number of reasons, including the integration risks described above. In addition, we may incur unexpected costs or delays as we transition our sales effort and customers to our performance management product we acquired from MindSolve. The integration of the MindSolve business may disrupt our business and result in the loss of customers or key employees or the diversion of the attention of management, any of which could have a negative effect upon our business and stock price.

Customer and employee uncertainty related to the MindSolve acquisition could harm SumTotal.

Uncertainty about the effect of our acquisition of MindSolve on customers, employees and partners may have an adverse effect on us. Former MindSolve employees may experience challenges in working for a larger public company, and, as a result, we may experience unexpected turnover. Customer concerns about changes or delays in our product roadmap of the combined company may negatively affect customer purchasing decisions, such as deferral of purchase decisions or reduced purchases. Customers could be reluctant to purchase the products and services of the combined company due to uncertainty about the direction of their technology, products and services, and willingness to support and service existing products which may be discontinued. We also amended our pre-existing performance management partnership, resulting in us competing for the same customers as the company with which we previously partnered. As a result, there may be a loss of revenue opportunities and market share for the combined company. If customers delay or defer purchasing decisions, or choose to purchase from a competitor, the revenue of the combined company could materially decline or any anticipated increases in revenue could be lower than expected.

Third parties have claimed, and may claim in the future, that we are infringing their intellectual property which could diminish the value of our products and services or deter customers from purchasing our products regardless of whether these claims are successful.

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, regardless of their merit, 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 miss our forecasts or industry analysts' forecasts, thereby causing a possible decline in the price of our common stock.

If third parties infringe our intellectual property or if we are unable to secure and protect our intellectual property, we may expend significant resources enforcing our rights or suffer competitive harm.

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. In addition, as part of our acquisition of MindSolve, we acquired its "Drag and Drop" patent and, as a result, patent protection may become a more important component of the methods we use to protect our proprietary technology. These legal protections afford only limited protection for our technology. 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 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.

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

We use 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 learning management solutions until equivalent technology, if available, is identified, licensed and integrated.

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 immediate repayment and foreclose on the loan.

Our credit facility with Wells Fargo Foothill requires compliance with certain restrictive covenants. These covenants include, but are not limited to, EBITDA levels, leverage ratios, and restrictions related to capital expenditures, indebtedness, distributions, investments and changes of control. If we breach any of these covenants, Wells Fargo Foothill could demand repayment of the outstanding debt, which as of September 30, 2007 was approximately $9.8 million, and, if we were unable to repay such amounts, 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. As a result of the 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 repay the debt, the credit facility provides for penalties for making pre-payments that would otherwise save us substantial future interest payments. The forced premature repayment of the loan could significantly reduce our cash position or, if we are unable to repay the loan, leave us without the ability to control which assets are sold to satisfy the loan or 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 revenue or the price of our common stock.

We may need additional financing in the future, which we may be unable to obtain on favorable terms or at all.

Even though in the second quarter of 2007 we closed on a registered direct offering of our common stock, raising over $32 million after fees and expenses, if our business does not generate the cash needed to finance our operations or growth, including potential business acquisitions, 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. We may be unable to obtain financing on terms favorable to us or at all. Further, it may be more difficult to obtain additional financing because of our credit facility. Unless waived by Wells Fargo Foothill, upon the sale or issuance by us of any shares of our capital stock, the credit facility requires us to prepay the outstanding principal amount of the term loan in an amount equal to 75% of the proceeds received by us in connection with such sale. If we do sell or issue additional shares of our capital stock, we believe we will be able to obtain a waiver from Wells Fargo Foothill. If we need to obtain financing and adequate funds are not available or are not available on acceptable terms, or we are not able to obtain a waiver from Wells Fargo Foothill, 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 revenue and stock price.

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

We host certain of our customers’ 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. We also 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 have experienced significant outages in the past and could, in the future, 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 or sue us for breach of contract, which would result in decreased revenue and a possible decline in the price of our common 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, including software solutions we host for some of our customers, depend on our ability to maintain and protect the computer systems needed for our day-to-day operations. For instance, a number of these computer systems are located in Mountain View, California on or near known earthquake fault zones and flood plains, or in Hyderabad, India where the infrastructure is not as robust as in the United States. 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 the price of our common stock.

If we are not able to adapt to rapidly changing technology and evolving industry standards or we do not meet our customer's needs on a timely basis, our products may become obsolete and we would lose market share.

The learning and performance management software markets are 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 also experience difficulties that delay or prevent the successful design, development, introduction or marketing of our products and services, which may harm our ability to attract new customers and retain existing customers.

Our products must be compatible with our customers' platforms and operating environments and to the extent commercially accepted platforms and operating systems change, we may need to develop new product lines in order to remain competitive.

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 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.

The performance management and learning management systems 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. Our competitors vary in size, scope and the breadth of products and services offered. We face competition from:

- other developers of performance management and learning management systems;
- providers of other performance management and learning management systems solutions;
- vendors of other enterprise software applications that are beginning to offer learning delivery and management functionality;
- large professional consulting firms and in-house information technology departments; and
- developers of web authoring tools.

Additionally, companies may choose to develop their own learning and performance management software internally rather than acquiring it from third parties.

There are relatively low barriers to entry in the performance management and learning management systems 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 would seriously harm our business and financial results.

Our core offering, the SumTotal 7 Series, integrates solutions addressing the learning management, performance management and compensation management segments of our market; however, our performance management solution was acquired in our acquisition of MindSolve and has only recently been integrated into our offering. Furthermore, our compensation management offering is not as fully developed and does not have the same market acceptance as the other modules of the SumTotal 7 Series. As a result, we may have difficulty competing against companies which focus on these segments rather than the entire learning and performance management market, or selling to customers who only need solutions in a specific segment.

Certain of our competitors have greater resources to develop or acquire the products and technologies necessary to compete against us.

The market for our products and services is highly competitive and subject to rapid change, with no single company accounting for a dominant share of the market. Nevertheless, several market research firms have predicted continued vendor consolidation over the next several years. Some of our existing and potential competitors, such as Oracle Corporation and SAP AG, have longer operating histories and significantly greater financial, technical, marketing and other resources. These companies not only have more resources to develop their own products and technologies internally but can also use such resources to acquire competing products and technologies through acquisitions or other strategic transactions and quickly enter the performance and learning management market and compete with us on both product offerings and pricing. As a result, we may not be able to compete successfully against such current and future competitors, and competitive pressures that we encounter may seriously harm our business.

The performance management and learning management systems software markets 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 and performance management solutions have traditionally been done using paper-based systems, desktop applications, spreadsheets, classroom settings, and human resource management systems. 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 depends on the extent to which companies implement performance and learning management software solutions for the design, development, delivery and management of their corporate learning needs and performance management solutions for rating, reviewing and evaluating individuals.

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 performance and learning management software solutions or performance management solutions, they may still choose to develop such solutions internally. If the use of performance and learning management software does not become widespread, or if companies choose to develop such software or solutions internally rather than acquiring them from third parties, then our performance and learning management software and performance management solutions will not be commercially successful.

Our operating results could be harmed by economic, political, regulatory and other risks associated with international sales and operations.

We, as well as our customers and our partners, are increasingly doing business outside of the United States. Accordingly, our business is subject to a number of risks inherent in international operations, including:

- difficulties and costs of recruiting and retaining qualified personnel in our offices outside of the United States;
- difficulties managing a geographically dispersed workforce with different learning styles and cultures;
- export controls, import tariffs and other barriers to trade;
- changes in laws or regulatory requirements, including tax laws;
- reduced protection of intellectual property rights;
- political and economic instability;
- reliability of infrastructure;
- difficulties managing a geographically dispersed sales organization; and
- fluctuations in currency exchange rates.

While we sell our products worldwide and we have experienced international partners, we have limited experience with sales and marketing in some countries, such as China, where we have recently opened a representative office. There can be no assurance that we will be able to market and sell our products in all of our targeted international markets. If our international efforts are not successful, our business and results of operations could be harmed.

Due to our significant operations in India, which has a rapidly growing technology market, our business is subject to certain risks that are not typically experienced to the same degree in the United States or elsewhere abroad.

We rely significantly on our research and development, professional services and technical support operations in Hyderabad, India to enable us to develop new products, complete customer implementation projects and new releases of our products on time and within established budgets and provide technical support. In recent years, increased growth and development of the technology market in general, and in Hyderabad specifically, has made it more difficult for us to hire and retain qualified technical employees and other personnel. In addition, it may be difficult to acquire additional space to support future growth.

Our efforts in Hyderabad are subject to a number of risks inherent in international operations. However, certain risks are particularly acute in India, such as:

- employee turnover;
- increasing salaries; and
- less reliable infrastructure.

If our India 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 Series, our ability to develop new versions of our SumTotal 7 Series and new products, and our ability to respond to customer or competitive demands would be harmed and we would lose sales opportunities and customers and might negatively impact our customer satisfaction.

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 Series, customer implementations, or in developing and releasing future versions of our product.

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:

- actual or anticipated variations in our operating results;
- changes in the estimates of our operating results or changes in recommendations by securities analysts;
- changes in conditions or trends in the learning and performance management market;
- 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;
- fluctuations in demand for our products, including due to seasonality;
- additions or departures of key personnel;
- foreign currency, interest rate, and fixed income risks; and
- market conditions in our industry, the industries of our customers and the economy as a whole.

Fluctuations in the price and trading volume of our common stock may prevent stockholders from selling 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.

Finally, a sustained decline in our stock price could help trigger an impairment analysis for the value of our goodwill and intangible assets, which then might result in an impairment based not only on stock price but other factors. The carrying value of our goodwill and intangible assets on September 30, 2007 was $68.5 million and $15.0 million, respectively.

We have experienced and may continue to experience turnover of senior management and key personnel, which could harm our business or operations.

Our success depends to a significant degree on the performance of the senior management team and other key employees. While certain of our Section 16 officers were granted two-year retention agreements in October 2005, at approximately the time our former chief executive officer resigned, these agreements expired in October 2007 and there is no guarantee that such officers will remain employed with us. We do not have employment agreements other than offer letters with our Section 16 officers or with any other key employee, and we do not maintain key person life insurance for any Section 16 officer or key employee. Furthermore, in August 2007, we announced the departure of our Chief Operating Officer, who would be leaving the Company by the end of the year. As a result of his departure, or the departure of any of our other Section 16 officers or key employees, there is a risk that we will be unable to effectively manage the Company and successfully meet operational and other challenges, which could harm our business.

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.

We announced a restructuring in October 2007 which included the termination of employment of a number of our employees. In connection with the employment terminations, we offered, in exchange for releases of claims against us, severance packages to each of the terminated employees. There is no assurance that all of the terminated employees will sign the releases. Those that choose not to, may choose to sue us for wrongful termination, in which case, even though we believe such suits would be meritless, such suits may divert management resources and will be costly to defend. The results of such litigation, if any may be difficult to predict, and a judgment or settlement may adversely affect our operating results, which may result in a lower stock price.

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, including customer implementation and product development, including customer implementation and product development. Moreover, we expect to rely increasingly 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 revenue generated from this investment.

Our internal controls and procedures may not be adequate to prevent or detect misstatements or errors.

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, if any, 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 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 Sarbanes-Oxley Section 404 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 Sarbanes-Oxley Section 404, 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 and 2005, 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 2007. During this process, 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 Sarbanes-Oxley 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 in fiscal 2005 and 2006. Although we remediated our material weaknesses in 2006, there is no assurance that future changes in our control procedures will not create other material weaknesses or that other material weaknesses will not be discovered in the future. 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 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 future material weaknesses identified by us or our independent registered public accounting firm, we will be unable to assert that 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.

Changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and the listing standards of the NASDAQ Global Market, have increased, and will continue to increase, our expenses as we devote resources to respond to the requirements. 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. 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.

Our operating expenses may be negatively affected by the impairment of goodwill and the impairment and amortization of 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 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 the 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 assets 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 assets and results of operations.

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, 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.

In June 2006, the FASB issued FIN No. 48, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on de-recognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. We adopted FIN No. 48 effective January 1, 2007. FIN No. 48 requires significant judgment in determining what constitutes an individual tax position as well as assessing the outcome of each tax position. Changes in judgment as to recognition or measurement of tax positions can materially affect the estimate of the effective tax rate and consequently, affect our operating results.

We may be limited in our use of net operating losses carry forwards.

Our ability to benefit from our deferred tax assets depends on us having sufficient future earnings to utilize our net operating loss ("NOL") carryforwards before they expire. We have established a valuation allowance against the future tax benefit for a number of our federal and state NOL carryforwards. We could be required to record an additional valuation allowance against our foreign or U.S. deferred tax assets if market conditions change materially and, as a result, our future earnings are, or are projected to be, significantly less than we currently estimate. Our NOL carryforwards are subject to review and potential disallowance upon audit by the tax authorities of the jurisdictions where the NOLs were incurred.

As of December 31, 2006, we had federal NOL and research and development ("R&D") tax credit carry-forwards available to offset future taxable income. Our ability to utilize net operating losses and credits may be subject to a substantial limitation due to the change in ownership, as defined in the Internal Revenue Code Section 382 and similar state provisions. The annual limitation may result in the expiration of net operating losses and credits before utilization.

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 result.

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. Further, the European Union has adopted various data protection regulations related to the confidentiality of personal data. While in May 2007, we became certified under the European Union Safe Harbor which regulates the collection of personal data, failure to comply with these various regulations could subject us to fines, and cause customers to lose confidence in our software products, thereby negatively affecting our revenue and expense

Terrorism and United States military actions may adversely affect our business.

In light of recent terrorist activity, political and military instability, and existing and possible United States 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 United States. In addition, such adverse political effects may have an adverse impact on economic conditions in the United States. Unfavorable economic conditions in the United States 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 compete effectively in the performance 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.

Anti-takeover provisions in our charter documents 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. In addition, our certificate of incorporation authorizes our Board of Directors, without stockholder approval, to issue up to 5,000,000 shares of undesignated preferred stock, which could be used to dilute the stock ownership of a potential hostile acquirer.

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

Purchases of Equity Securities – Certain information regarding purchases made by us or on our behalf, or any affiliated purchaser (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934, as amended) of our common stock during the quarter ended September 30, 2007 is provided below:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet be Purchased Under the Programs (in thousands) (1)
July 1-31, 2007	—	$ —	—	$ —
August 1-31, 2007	383,300	5.59	383,300	12,859
September 1-30, 2007	—	—	—	—
Third Quarter 2007	383,300	$ 5.59	383,300	$ 12,859

(1) On August 20, 2007, we announced that our Board of Directors approved a share repurchase program pursuant to which we may repurchase up to $15.0 million of shares of our common stock from time to time at prices and on terms satisfactory to us. The 2007 program does not have an expiration date.

Item 6. Exhibits

(a) Exhibits

3.1	Amended and Restated Certificate 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)
10.1	Fifth Amendment to the Credit Agreement dated August 17, 2007 by and among the lender signatory thereto, Wells Fargo Foothill, Inc. and SumTotal Systems
10.2*	Transition Agreement dated September 24, 2007 between David Crussell and SumTotal Systems
31.1	Certification 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	Certification 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.

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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, 2007	/s/ NEIL J. LAIRD
Date	Neil J. Laird Chief Financial Officer (Duly Authorized Officer and Chief Financial and Chief Accounting Officer)

Exhibit Index

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* 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.

Exhibit 10.1

Execution Copy

FIFTH AMENDMENT TO CREDIT AGREEMENT

THIS FIFTH AMENDMENT TO CREDIT AGREEMENT (this " Amendment "), dated as of August 17, 2007, is entered into by and among the Lenders signatory hereto, **WELLS FARGO FOOTHILL, INC.** , a California corporation, in its capacity as Agent for the Lenders and Bank Product Providers (in such capacity, " Agent "), and **SUMTOTAL SYSTEMS, INC.** , a Delaware corporation (" Borrower "). Terms used herein without definition shall have the meanings ascribed to them in the Credit Agreement defined below.

RECITALS

A. The Lenders, Agent and Borrower have previously entered into that certain Credit Agreement dated as of October 4, 2005, as amended as of October 21, 2005, as of August 11, 2006, as of November 13, 2006, and as of June 19, 2007 (as so amended, and as further amended, modified and supplemented from time to time, the " Credit Agreement "), pursuant to which the Lenders have made certain loans and financial accommodations available to Borrower.

B. The Borrower has requested that the Lenders and the Agent agree to certain additional amendments to the Credit Agreement, and the Lenders and the Agent have agreed to such request, subject to the terms and conditions hereof.

AGREEMENT

NOW, THEREFORE, in consideration of the foregoing and the mutual covenants herein contained, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereby agree as follows:

1. Amendment to Credit Agreement . Subject to and upon the conditions hereof, the Credit Agreement is hereby amended, effective as of the date of satisfaction of the conditions set forth in Section 2 hereof, as follows:

> Section 6.10 of the Credit Agreement is hereby amended by inserting the following at the end of such section:
>
> Notwithstanding the foregoing, and in addition to the permitted Stock repurchases or redemptions by Borrower of Stock held by its employees or consultants pursuant to any employee stock ownership plan or similar plan upon termination, retirement or death of any such employee in accordance with the proviso above, from the period from August 20, 2007 until and including August 19, 2008, Borrower may, in one or more transactions, repurchase or redeem common Stock of Borrower, provided that (i) the aggregate amount paid for such Stock in connection with such repurchases or redemption does not exceed $15,000,000, exclusive of any commissions or similar fees, (ii) both prior to and after each such repurchase or redemption, no Default or Event of Default shall have occurred or be continuing, and (iii) immediately after giving effect to such repurchase or redemption, the sum of Excess Availability *plus* Qualified Cash shall equal or exceed $15,000,000.

2. Effectiveness of this Amendment. Agent must have received the following items, in form and content acceptable to Agent, before this Amendment is effective:

(a) Amendment; Acknowledgments and Releases. This Amendment and the attached Acknowledgment and Release by Subordinating Creditors, each duly executed in a sufficient number of counterparts for distribution to all parties.

(b) Representations and Warranties; No Default. (i) The representations and warranties set forth herein and in the Credit Agreement must be true and correct in all material respects on and as of the date hereof (after giving effect to any updated information supplied to the Agent), as though made on and as of the date hereof (except to the extent that such representations and warranties relate solely to the Closing Date or another earlier date); and (ii) no event shall have occurred and be continuing that constitutes a Default or an Event of Default.

(c) Other. All other documents and legal matters in connection with the transactions contemplated by this Amendment or requested by Agent shall have been delivered, executed or recorded and shall be in form and substance satisfactory to Agent in its sole discretion.

3. Representations and Warranties. Borrower represents and warrants as follows:

(a) Authority. Each of the Borrower and each Subsidiary has the requisite corporate power and authority to execute and deliver this Amendment, and to perform its obligations hereunder and under the Loan Documents (as amended or modified hereby) to which it is a party.

(b) Enforceability. This Amendment has been duly executed and delivered by Borrower. This Amendment is the legal, valid and binding obligation of Borrower, enforceable against Borrower in accordance with its terms (except as enforcement may be limited by equitable principles or by bankruptcy, insolvency, reorganization, moratorium, or similar laws relating to or limiting creditors' rights generally), and is in full force and effect.

(c) Representations and Warranties. After giving effect to any updated information supplied by Borrower, the representations and warranties of Borrower and its Subsidiaries contained in each Loan Document (other than any such representations or warranties that, by their terms, are specifically made as of the Closing Date or another date other than the date hereof) that are qualified by materiality are true, accurate and complete as though made on and as of the date hereof, and that are not qualified by materiality are true, accurate and complete in all material respects as though made on and as of the date hereof.

(d) Due Execution. The execution, delivery and performance of this Amendment are within the power of Borrower, have been duly authorized by all necessary corporate action and no other corporate proceedings are necessary to consummate such transactions, have received all necessary governmental approval, if any, and do not contravene any law or any contractual restrictions binding on Borrower.

(e) Disclosure. All factual information (taken as a whole) furnished by or on behalf of Borrower or its Subsidiaries in writing to Agent or any Lender for purposes of or in connection with this Amendment, the other Loan Documents or any transaction contemplated herein or therein is, and all other such factual information (taken as a whole) hereafter furnished by or on behalf of Borrower or its Subsidiaries in writing to Agent or any Lender will be, true and accurate, in all material respects, on the date as of which such information is dated or certified and not incomplete by omitting to state any fact necessary to make such information (taken as a whole) not misleading in any material respect at such time in light of the circumstances under which such information was provided.

(f) No Default . No event has occurred and is continuing that constitutes a Default or an Event of Default.

4. Choice of Law . The validity of this Amendment, its construction, interpretation and enforcement, the rights of the parties hereunder, shall be determined under, governed by, and construed in accordance with the laws of the State of New York.

5. Counterparts . This Amendment may be executed in any number of counterparts and by different parties and separate counterparts, each of which when so executed and delivered, shall be deemed an original, and all of which, when taken together, shall constitute one and the same instrument. Delivery of an executed counterpart of a signature page to this Amendment by telefacsimile or other similar method of electronic transmission shall be effective as delivery of a manually executed counterpart of this Amendment.

6. Reference to and Effect on the Loan Documents .

(a) Upon and after the effectiveness of this Amendment, each reference in the Credit Agreement to “this Agreement”, “hereunder”, “hereof” or words of like import referring to the Credit Agreement, and each reference in the other Loan Documents to “the Credit Agreement”, “thereof” or words of like import referring to the Credit Agreement, shall mean and be a reference to the Credit Agreement as modified and amended hereby.

(b) Except as specifically amended or modified above, the Credit Agreement and all other Loan Documents, are and shall continue to be in full force and effect and are hereby in all respects ratified and confirmed and shall constitute the legal, valid, binding and enforceable obligations of Borrower.

(c) The execution, delivery and effectiveness of this Amendment shall not, except as expressly provided herein, operate as a waiver of any right, power or remedy of the Lender Group under any of the Loan Documents, nor constitute a waiver of any provision of any of the Loan Documents.

(d) To the extent that any terms and conditions in any of the Loan Documents shall contradict or be in conflict with any terms or conditions of the Credit Agreement, after giving effect to this Amendment, such terms and conditions are hereby deemed modified or amended accordingly to reflect the terms and conditions of the Credit Agreement as modified or amended hereby.

7. Integration . This Amendment, together with the other Loan Documents, incorporates all negotiations of the parties hereto with respect to the subject matter hereof and is the final expression and agreement of the parties hereto with respect to the subject matter hereof.

8. Severability . In case any provision in this Amendment shall be invalid, illegal or unenforceable, such provision shall be severable from the remainder of this Amendment and the validity, legality and enforceability of the remaining provisions shall not in any way be affected or impaired thereby.

[remainder of page intentionally left blank]

IN WITNESS WHEREOF, the parties have entered into this Amendment as of the date first above written.

SUMTOTAL SYSTEMS, INC. ,
a Delaware corporation

By: /s/ Neil J. Laird
Name: Neil J. Laird
Title: Chief Financial Officer

[Signature Page 1 to Fifth Amendment]

WELLS FARGO FOOTHILL, INC. ,
a California corporation, as Agent and a Lender

By: /s/ Thomas Forbath
Name: Thomas Forbath
Title: Vice President

[Signature Page 2 to Fifth Amendment]

ACKNOWLEDGMENT AND RELEASE BY SUBORDINATING CREDITORS

Dated as of August 17, 2007

In connection with the foregoing Fifth Amendment to Credit Agreement (the " Amendment "), each of the undersigned, being a Creditor (each a " Subordinating Creditor " and collectively, the " Subordinating Creditors ") under the Intercompany Subordination Agreement (as defined in the Credit Agreement referenced in the Amendment), hereby confirms and agrees that the Intercompany Subordination Agreement is and shall continue to be, in full force and effect and is hereby ratified and confirmed in all respects except that, upon the effectiveness of, and on and after the date of the foregoing Amendment, each reference in the Intercompany Subordination Agreement to the Credit Agreement (as defined in the Intercompany Subordination Agreement), "thereunder", "thereof" or words of like import referring to the Credit Agreement, shall mean and be a reference to the Credit Agreement as amended or modified by the Amendment. Although Agent and the Lenders have informed Subordinating Creditors of the matters set forth in the Amendment, and Subordinating Creditors have acknowledged the same, each Subordinating Creditor understands and agrees that neither the Lender Group nor the Bank Product Providers have any duty under the Credit Agreement, the Intercompany Subordination Agreements or any other agreement with any Subordinating Creditor to so notify any Subordinating Creditor or to seek such an acknowledgment, and nothing contained herein is intended to or shall create such a duty as to any advances or transaction hereafter.

CREDITORS:

SUMTOTAL SYSTEMS, INC.,
a Delaware corporation

By: /s/ Neil J. Laird
Name: Neil J. Laird
Its: Chief Financial Officer

SUMTOTAL SYSTEMS NETHERLANDS BV,
a besloten vennootschap organized under the laws of the Netherlands

By: Neil J. Laird
Name: Neil J. Laird
Title: Chief Financial Officer

SUMTOTAL SYSTEMS U.K. LTD.,
a private limited company organized under the laws of the United Kingdom

By: Neil J. Laird
Name: Neil J. Laird
Title: Chief Financial Officer

[Acknowledgment and Release by Subordinating Creditors to Fifth Amendment]

PATHLORE SOFTWARE LIMITED,
a private limited company organized under the laws of the United Kingdom

By: Neil J. Laird
Name: Neil J. Laird
Title: Director

[Acknowledgment and Release by Subordinating Creditors to Fifth Amendment]

Exhibit 10.2

September 24, 2007

David Crussell
1530 Rose Lane
Pleasanton, CA 94566

Re: Transition Agreement

Dear Dave:

This letter sets forth the terms of the transition agreement (the “Agreement”) between you and SumTotal Systems, Inc. (the “Company”).

1. **Separation Date.** As discussed, your last day of employment with the Company shall be December 31, 2007 (the “Separation Date”). Of course, the Company will accelerate the Separation Date in the event that you materially breach this Agreement, the Confidentiality Agreement or any Company policy. Your employment with the Company from the date of this letter through the Separation Date shall be referred to as the “Transition Period” for the purposes of this Agreement, and will be subject to the following terms and conditions.

2. **Transition Duties** . You shall continue to be employed by the Company and make yourself available to work for up to 40 hours per month (the “Transition Period”), subject to all of the standard policies and procedures of the Company. You shall, within a reasonable period of time following any requests made of you by the Company’s Chief Executive Officer (“CEO”): (i) discharge and perform any and all duties reasonably requested of you by the CEO or his designee; (ii) take all steps reasonably satisfactory to the CEO to ensure the orderly transition of all matters that you have handled during the course of your employment with the Company; and (iii) provide transition briefing information to the CEO as he requests. All such requests by the CEO shall be made with reasonable notice to you in advance, such that you need not be “on call” during the Transition Period and nothing in this Paragraph shall in any way limit your right to attend to personal matters during the Transition Period, even if attending to such personal matters renders you immediately unavailable to respond to the requests of the CEO. During the Transition Period, you will not have authority to bind the Company or make management decisions, unless expressly authorized in writing in advance by the CEO, or his designee.

3. **Salary Continuation and General Employee Benefits** . Through the Separation Date, you will continue to receive your current base salary, paid in the Company’s ordinary payroll cycle and subject to standard deduction and withholdings. You will also continue to be eligible for the Company’s standard employment benefits pursuant to the terms, conditions and limitations of the benefit plans.

4. **Vesting of Equity Awards.** To the extent consistent with the terms of the equity awards provided to you in connection with your employment (the "Equity Awards") and the Company's applicable equity incentive plans (the "Equity Plans"), your Equity Awards will continue to vest during the Transition Period in accordance with the operative agreements and the applicable Equity Plans. You and the Company agree that, effective as of the Separation Date, your "service" to the Company (for the purposes of the Equity Awards and the applicable Equity Plans) will cease, which means that vesting of all Equity Awards shall cease as of the Separation Date. All other terms of the Equity Awards remain subject to the terms and conditions of the operative agreements and the applicable Equity Plans. Accordingly, your right to exercise any vested shares shall be in accordance with the applicable Equity Awards and Equity Plans.

5. **Accrued Salary and Paid Time Off** . On the Separation Date, regardless of whether you sign this Agreement, you will be paid all accrued and unused paid time off earned through that date, subject to standard payroll deductions and withholdings. You are entitled to these payments by law. You will continue to accrue paid time off during the Transition Period at the same rate you were earning such benefit prior to your execution of this Agreement.

6. **Severance** . The Company will pay you severance in the amount of $233,333, which is equivalent to eight months base salary (the "Severance Payment"). The Severance Payment shall be made in one lump sum, on the payroll date following the effective date of the Separation Date Release. The Severance Payment will be subject to standard payroll deductions and withholdings, the satisfaction of any outstanding debts to the Company, and your timely return of all Company Property.

7. **Executive and Management Bonus Plan.** Although you will have not earned any bonus or incentive compensation under the terms of the Company's Executive and Management Bonus Plan (the "Bonus Plan") through the end of December 31, 2007, and the Company is not obligated to make any payment to you under the Bonus Plan, pursuant to this Agreement, assuming you sign and allow to become effective this Agreement and the Separate Date Release, the Company will pay you a pro-rated amount (eight-ninths for third quarter and eight-twelfths for fourth quarter) of the amount you would have normally received for the financial component payout for the third and fourth quarters of 2007 if you had remained fully employed through December 31, 2007 and the plan payout date applicable to the third and fourth quarters. These payments shall be made on the same terms and at the same time all other eligible employees receive the third and fourth quarter 2007 financial component payouts. You expressly acknowledge that you are not entitled to any payout of the MIT component of the Bonus Plan for fiscal year 2007.

8. **Retention Bonus.** Provided you comply with the terms of this Agreement and the Retention Bonus Agreement, you shall receive your retention bonus of $206,250 on the first payroll after October 19, 2007 ("Retention Bonus"). Such Retention Bonus shall be subject to the Company's standard payroll deductions, including tax and payroll withholdings.

9. **Health Care Coverage.** To the extent provided by the federal COBRA law or, if applicable, state insurance laws (collectively, "COBRA"), and by the Company's current group health insurance policies, you will be eligible to continue your group health insurance benefits at your own expense after the Separation Date. On or after the Separation Date, you will be provided with a separate notice more specifically describing your rights and obligations to continuing health insurance coverage under the COBRA laws. Although the Company is not otherwise obligated to do so, if you enter into this Agreement, comply with your obligations hereunder, and, on or timely after the Separation Date, you sign, date, return to the Company and allow to become effective the Separation Date Release, the Company agrees to reimburse your COBRA premiums (the "COBRA Reimbursement") sufficient to continue your group health insurance coverage at its current level (including dependent coverage, if any), for eight months through August 31, 2008, *provided however that,* the Company's obligation to provide the COBRA Reimbursement ceases immediately if you become eligible for group health insurance coverage through a new employer or if you materially breach this Agreement or the Confidentiality Agreement. You agree to immediately notify the Company's Vice President, Human Resources in writing if you become eligible for group health insurance coverage through a new employer at any time prior to August 31, 2008.

10. **Other Compensation or Benefits and Agreements.** You acknowledge that, except as provided in this Agreement, you have not earned and will not receive any other compensation, including without limitation salary, bonus, incentive compensation, or severance, or any benefits before or after the Separation Date, with the exception of any vested right you may have under the express terms of a written ERISA-qualified benefit plan (e.g., 401(k) account) or any vested Equity Awards. You expressly acknowledge that your Amended and Restated Change of Control Agreement dated August 31, 2006 ("Change of Control Agreement") is hereby terminated, effective on the Effective Date of this Agreement. You also expressly acknowledge that the following agreements shall remain in full force and effect: (a) Retention Bonus Agreement dated October 25, 2005, (b) Employee Invention, Confidentiality, Unfair Competition, and NonSolicitation Agreement dated May 17, 2004, and (c) Indemnification Agreement dated April 14, 2004 ("Indemnification Agreement").

11. **Noncompetition.** From the Effective Date through August 31, 2008, you will not perform, directly or indirectly, the same or similar services for any Competitor of the Company, and you will not engage in any business activities competitive with the Company on your own behalf (or prepare to engage in such activities). You acknowledge and agree that: your performance of any such services would inevitably

make use of the confidential or proprietary information of the Company; you have had access to competitively valuable such confidential and proprietary information during the course of your employment for the Company (including but not limited to: information regarding the Company's product research and development, "roadmaps," sales and marketing plans, partnership plans, business plans, proposed merger and acquisition activities, finances and operations, personnel); and that any breach of the provisions of this section would be material and cause irreparable harm to the Company and provide the basis for injunctive relief. For purposes of this Agreement, "Competitor" means any company, partnership, sole proprietorship, or other entity which is, or plans or proposes to be, competitive with the Company, or any of the Company's lines of business or planned or proposed lines of business. If you violate this section, or Sections 14 or 15 of this Agreement, you will forfeit and not be entitled to receive any unpaid payments under the 2007 Executive and Management Bonus Plan as set forth in Section 7, or Severance Payment as set forth in Section 6, (collectively, "Non-Compete Payments") and be required to reimburse the Company an amount equal to the unpaid Non-Compete Payments.

12. **Expense Reimbursements.** You agree that, on or before the Separation Date, you will submit your final documented expense reimbursement statement reflecting all business expenses you incurred through the Separation Date, if any, for which you seek reimbursement. The Company will reimburse you for these expenses pursuant to its regular business practice.

13. **Return of Company Property.** Except for documents or materials that the Company authorizes you in writing to retain for purposes of performing the services during the Transition Period (if any) and except for your Company laptop and phone, which you may keep, on the Separation Date, you shall return to the Company all Company documents (and all copies thereof) and other Company property that you have in your possession or control, including, but not limited to, sales reports, sales and marketing information, client information, Company products, samples, equipment, files, notes, correspondence, memoranda, email, computer-recorded information, electronic information, drawings, records, compilations of data, plans, forecasts, operational and financial information, research and development information, personnel information, product and manufacturing information, specifications, tangible property, credit cards, entry cards, identification badges and keys; and any materials of any kind that contain or embody any proprietary or confidential information of the Company (and all reproductions thereof in whole or in part). You agree that you will make a diligent search to locate any such documents, property and information on the Separation Date. In addition, if you have used any personally owned computer, server, or e-mail system to receive, store, review, prepare or transmit any Company confidential or proprietary data, materials or information, then on or before the Separation Date you shall provide the Company with a computer-useable copy of such information and then permanently delete and expunge such Company confidential or proprietary information from those systems without retaining any copy or reproduction; and you shall provide the Company access to your system as requested to verify that the necessary copying

and/or deletion is done. If you have any technical difficulties deleting such information, you should contact Richard Walsh at the Company, who will either assist you in the deletion process or waive your obligation to delete the specified information. Your failure to timely comply with this paragraph will be considered a material breach of this Agreement.

14. **Proprietary Information Obligations.** You hereby acknowledge and reaffirm your continuing obligations under your Employee Invention, Confidentiality, Nonsolicitation, and Noncompetition Agreement (the "Confidentiality Agreement"), a copy of which is attached hereto as **Exhibit A** .

15. **Post-Employment Period Restrictions.** You hereby agree that, during the Transition Period and for one (1) year after the Separation Date, you will comply with the post-employment period restrictions (the "Post-Employment Period Restrictions") set forth in sections 16 and 17 of this Agreement.

16. **Nonsolicitation of Business and Customers.** You will not, directly or indirectly, solicit or attempt to solicit any business from any company or other entity (whether business, government, or otherwise), on behalf of a Competitor, which, during the one year preceding the Effective Date (i) you had any direct or indirect (e.g. through a third party) contact or association with the customer, alliance, partner or vendor, or (ii) the customer, alliance, partner or vendor was under your supervision.

17. **Nonsolicitation of Employees.** You will not, directly or indirectly, induce, encourage, solicit, attempt to solicit or cause to be solicited any employee or contractor of the Company to leave his or her employment, terminate his or her work for the Company, or refrain from providing services to the Company, or any of its subsidiaries or affiliates.

18. **Confidentiality.** The provisions of this Agreement will be held in strictest confidence by you and the Company and will not be publicized or disclosed in any manner whatsoever; *provided, however,* that: (a) you may disclose this Agreement in confidence to your immediate family; (b) the parties may disclose this Agreement in confidence to their respective attorneys, accountants, auditors, tax preparers, and financial advisors; (c) the Company may disclose this Agreement as necessary to fulfill standard or legally required corporate reporting or disclosure requirements; and (d) the parties may disclose this Agreement insofar as such disclosure may be necessary to enforce its terms or as otherwise required by law.

19. **Nondisparagement.** You agree not to disparage the Company or the Company's current and former officers, directors, employees, shareholders, parents, subsidiaries, affiliates, and agents, in any manner likely to be harmful to them or their business, business reputation or personal reputation; and the Company (through its officers and directors) agrees not to disparage you in any manner likely to be harmful to you or your business or personal reputation; *provided that* the parties may respond accurately and fully to any request for information if required by legal process.

20. **Cooperation.** You agree to cooperate fully with the Company in connection with its actual or contemplated defense, prosecution, or investigation of any claims or demands by or against third parties, or other matters arising from events, acts, or failures to act that occurred during the period of your employment by the Company. Such cooperation includes, without limitation, making yourself available to the Company upon reasonable notice, without subpoena, to provide complete, truthful and accurate information in witness interviews, depositions and trial testimony. The Company will reimburse you for reasonable out-of-pocket expenses you incur in connection with any such cooperation (excluding forgone wages, salary, or other compensation) and will make reasonable efforts to accommodate your scheduling needs. In addition, you agree to execute all documents (if any) necessary to carry out the terms of this Agreement.

21. **No Admissions.** The promises and payments in consideration of this Agreement shall not be construed to be an admission of any liability or obligation by either party to the other party, and neither party makes any such admission.

22. **No Voluntary Adverse Action.** You agree that you will not voluntarily assist any person in preparing, bringing, or pursuing any litigation, arbitration, administrative claim or other formal proceeding against the Company, its parents, subsidiaries, affiliates, officers, directors, employees or agents, unless pursuant to subpoena or other compulsion of law.

23. **Release of Claims.** In exchange for consideration provided to you by this Agreement that you are not otherwise entitled to receive, you hereby generally and completely release the Company and its current and former directors, officers, employees, shareholders, partners, agents, attorneys, predecessors, successors, parent and subsidiary entities, insurers, affiliates, and assigns from any and all claims, liabilities and obligations, both known and unknown, that arise out of or are in any way related to events, acts, conduct, or omissions occurring prior to or on the date that you sign this Agreement. This general release includes, but is not limited to: (a) all claims arising out of or in any way related to your employment with the Company, or the termination of that employment; (b) all claims related to your compensation or benefits from the Company, including salary, bonuses, commissions, vacation pay, expense reimbursements, severance pay, fringe benefits, stock, stock options, or any other ownership interests in the Company; (c) all claims for breach of contract, wrongful termination, and breach of the implied covenant of good faith and fair dealing (including but not limited to claims arising from or based on the Bonus Plan, and the Change of Control Agreement); (d) all tort claims, including claims for fraud, defamation, emotional distress, and discharge in violation of public policy; and (e) all federal, state, and local statutory claims, including claims for discrimination, harassment, retaliation, attorneys' fees, or other claims arising under the federal Civil Rights Act of 1964 (as amended), the federal Americans with Disabilities Act of 1990, the federal Age Discrimination in Employment Act (as amended) ("ADEA"), and the California Fair Employment and Housing Act (as amended). You represent that you

have no lawsuits, claims or actions pending in your name, or on behalf of any other person or entity, against the Company or any other person or entity subject to the release granted in this paragraph. Notwithstanding the foregoing, you are not hereby releasing the Company from any obligation undertaken in this Agreement; or any obligation the Company may otherwise have to indemnify you for your acts within the course and scope of your employment with the Company, pursuant to your Indemnification Agreement.

24. **ADEA Waiver.** You hereby acknowledge that you are knowingly and voluntarily waiving and releasing all rights, if any, you may have under the ADEA and that the consideration given for the waiver and release in the preceding paragraph is in addition to anything of value to which you were already entitled. You further acknowledge that you have been advised by this writing, as required by the ADEA, that: (a) your waiver and release do not apply to any rights or claims that may arise after the date that you sign this Agreement; (b) you should consult with an attorney prior to signing this Agreement (although you may decide voluntarily not to do so); (c) you have twenty-one (21) days within which to consider this Agreement (although you may choose voluntarily to sign this Agreement earlier); (d) you have seven (7) days following your signing of this Agreement to revoke this Agreement (by a written revocation received by the CEO); and (e) this Agreement will not be effective until the eighth day after this Agreement has been signed both by you and by a duly authorized officer of the Company (the "Effective Date").

25. **Section 1542 Waiver.** In giving the release herein, which includes claims which may be unknown to you at present, you acknowledge that you have read and understand Section 1542 of the California Civil Code, which reads as follows:

> **"A general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor."**

You hereby expressly waive and relinquish all rights and benefits under that section and any law of any other jurisdiction of similar effect, including but not limited to your release of any unknown or unsuspected claims herein.

26. **Dispute Resolution.** To aid in the rapid and economical resolution of any disputes which may arise under this Agreement, you and the Company agree that any and all claims, disputes or controversies of any nature whatsoever arising from or regarding the interpretation, performance, negotiation, execution, enforcement or breach of this Agreement, will be resolved by confidential, final and binding arbitration conducted before a single arbitrator with JAMS, Inc. ("JAMS") in San Francisco, California, under JAMS' then-applicable arbitration rules. **The parties acknowledge that by agreeing to this arbitration procedure, they waive the right to resolve any such dispute through a trial by jury, judge or administrative proceeding.** You will have the right to be represented by legal counsel at any arbitration proceeding. The

arbitrator shall: (a) have the authority to compel adequate discovery for the resolution of the dispute and to award such relief as would otherwise be available under applicable law in a court proceeding; and (b) issue a written statement signed by the arbitrator regarding the disposition of each claim and the relief, if any, awarded as to each claim, the reasons for the award, and the arbitrator's essential findings and conclusions on which the award is based. The Company shall bear the JAMS arbitration fees and administrative costs. Nothing in this Agreement shall prevent either you or the Company from obtaining injunctive relief in court to prevent irreparable harm pending the conclusion of any such arbitration. The parties agree that the arbitrator shall award reasonable attorneys fees and costs to the prevailing party in any action brought hereunder, and the arbitrator shall have discretion to determine the prevailing party in an arbitration where multiple claims may be at issue.

27. **General.** This Agreement, including the Exhibits, constitutes the complete, final and exclusive embodiment of the entire agreement between you and the Company with regard to the subject matter hereof. It is entered into without reliance on any promise or representation, written or oral, other than those expressly contained herein, and it supersedes any other such promises, warranties or representations, including but not limited to the Change of Control Agreement. This Agreement may not be modified or amended except in a writing signed by both you and a duly authorized officer of the Company. This Agreement will bind the heirs, personal representatives, successors and assigns of both you and the Company, and inure to the benefit of both you and the Company, their heirs, successors and assigns. If any provision of this Agreement is determined to be invalid or unenforceable, in whole or in part, this determination will not affect any other provision of this Agreement and the provision in question shall be deemed modified so as to be rendered enforceable consistent with the intent of the parties insofar as possible under applicable law. This Agreement will be governed by the laws of the State of California without regard to conflicts of law principles. Any ambiguity in this Agreement shall not be construed against either party as the drafter. Any waiver of a breach of this Agreement, or rights hereunder, shall be in writing in order to be effective and shall not be deemed to be a waiver of any successive breach or rights hereunder. This Agreement may be executed in counterparts which shall be deemed to be part of one original, and facsimile signatures shall be equivalent to original signatures.

28. **Compliance with Section 409A of the Internal Revenue Code of 1986, as amended.** This Agreement is intended to comply with Section 409A of the Code (or any regulations or rulings thereunder), and shall be construed and interpreted in accordance with such intent. Notwithstanding anything to the contrary in this Agreement, the Company shall have the authority and the obligation to delay the payment of any amounts or the provision of any benefits under this Agreement to the extent it deems necessary or appropriate to comply with Section 409A(a)(2)(B)(i) of the Code (relating to payments made to certain "key employees" of certain publicly-traded companies). In such event, the payment of amounts or the provision of any benefits under this Agreement to which you are entitled will be delayed until the first

payroll immediately following the expiration date of the six month "waiting" period required by Section 409A. Any provision of this Agreement that would cause the payment of any benefit to fail to satisfy Section 409A of the Code shall have no force and effect until amended to comply with Code Section 409A (which amendment may be retroactive to the extent permitted by the Code or any regulations or rulings thereunder).

If this Agreement is acceptable to you, please sign below and return the original to Erika Rottenberg within twenty-one (21) days after your receipt of this Agreement. The offer contained in this Agreement will automatically expire if the Company does not receive the fully executed Agreement from you by that date. Do not sign the Separation Date Release attached as Exhibit B until the Separation Date.

This Agreement shall be subject to the approval of SumTotal's Board of Directors and shall not be a binding obligation on the Company until such approval is obtained, if it is obtained.

The Company looks forward to continuing to work with you during the Transition Period and wishes you the best in your future endeavors.

Sincerely,

SumTotal Systems, Inc.

By: /s/ Erika Rottenberg 9/28/07

Understood and Agreed:

/s/ David Crussell
David Crussell

9/24/07
Date

Enclosures:

Exhibit A – Employee Invention, Confidentiality, Nonsolicitation, and Noncompetition Agreement

Exhibit B – Separation Date Release

Exhibit 31.1

**CERTIFICATION 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 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 the 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, 2007

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

Exhibit 31.2

CERTIFICATION 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 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 the 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, 2007

/s/ NEIL J. LAIRD
Neil J. Laird
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, 2007 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, 2007

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, 2007 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
Chief Financial Officer
Date: November 8, 2007