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CATO CORP
Form 8-A12B
May 28, 2002

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 8-A

FOR REGISTRATION OF CERTAIN CLASSES OF SECURITIES PURSUANT TO
SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

THE CATO CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

Delaware

56-0484485

(State of Incorporation or Organization)

(I.R.S. Employer Identification No.)

8100 Denmark Road, Charlotte, North Carolina

28273

(Address of Principal Executive Offices)

(Zip Code)

If this form relates to the registration of a class of securities pursuant to
Section 12(b) of the Exchange Act and is effective upon filing pursuant to
General Instruction A.(c), please check the following box. [X]

If this form relates to the registration of a class of securities pursuant to
Section 12(g) of the Exchange Act and is effective pursuant to General
Instruction A.(d), please check the following box. []

Securities Act Registration Statement file number to which this form relates:

(If applicable)

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

Title of Each Class to be so Registered	Name of Each Exchange on Which Each Class is to be Registered
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Class A Common Stock

New York Stock Exchange

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

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ITEM 1. DESCRIPTION OF REGISTRANT'S SECURITIES TO BE REGISTERED.

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The Registrant's Articles of Incorporation authorize the issuance of up to 50,000,000 shares of Class A Common Stock, 15,000,000 shares of Class B common Stock and 100,000 shares of Preferred Stock. As of March 22, 2002, there were 19,395,237 shares of Class A Common Stock and 5,822,649 shares of Class B Common Stock outstanding. There were no shares of Preferred stock outstanding.

The Registrant's Class A Common Stock has been approved for listing, and will begin trading, on the New York Stock Exchange on June 13, 2002 under the symbol CTR.

CLASS A COMMON STOCK AND CLASS B COMMON STOCK

The powers, designations, preferences, rights and privileges of the holders of Class A Common Stock and the holders of Class B Common Stock are identical, except as described below. Holders of Class A Common Stock are entitled to one vote per share and holders of Class B Common Stock are entitled to 10 votes per share on all matters submitted to stockholders. Holders of Class A Common Stock vote with holders of Class B Common Stock as a single class, except for matters as to which applicable law requires the approval of one or both classes voting separately. Among other things, the Delaware General Corporation Law requires a separate class vote for any amendment to the Company's charter that would affect adversely the rights and preferences of that class of stock. The number of authorized shares of either Class A Common Stock or Class B Common Stock may be increased, however, by the affirmative vote of a majority of all votes entitled to be voted by the holders of Class A Common Stock and Class B Common Stock voting as a single class.

Subject to preferences that may be applicable to any shares of Preferred Stock outstanding at the time, the holders of Class A Common Stock and Class B Common Stock are entitled to receive such separate dividends as may be declared by the Board of Directors out of funds legally available therefor. No cash dividend may be paid to the holders of Class B Common Stock unless an equal or greater dividend, on a per share basis, is paid to the holders of Class A Common Stock. In case of dividends payable in stock of the Company other than Preferred Stock, only shares of Class A Common Stock may be distributed with respect to Class A Common Stock, and only shares of Class B Common Stock, in an amount per share equal to the amount per share distributed with respect to the Class A Common Stock, may be distributed with respect to Class B Common Stock.

No stock dividend may be paid, and no stock split, reverse stock split, reclassification or recapitalization of the Class A Common Stock, and no such transactions resulting in a decrease of the number of outstanding shares of Class B Common Stock, may be effected unless the ratio of the number of shares of Class B Common Stock outstanding immediately following such transaction to the number of shares of Class B Common Stock outstanding immediately prior to such transaction is the same as the ratio of the number of shares of Class A Common Stock outstanding immediately following such transaction to the number of shares of Class A Common Stock outstanding immediately prior to such transaction.

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Subject to the rights of the holders of any shares of Preferred Stock that may be outstanding at the time, in the event of the liquidation, dissolution or winding up of the Company, holders of Class A Common Stock are entitled to receive a preferential distribution of \$1.00 per share out of the net assets of the Company. After such payment to the holders of Class A Common Stock, or provision therefor, holders of Class A Common Stock and holders of Class B Common Stock are entitled to share ratably in the remaining net assets of the

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Company. Holders of Class A Common Stock and Class B Common Stock do not have cumulative voting, preemptive or redemption rights. Holders of Class B Common Stock may elect at any time to convert their shares of Class B Common Stock, on a one-for-one basis, into shares of Class A Common Stock. Holders of Class A Common Stock have no conversion privileges.

Restrictions on Transfers

The Company's charter provides that shares of Class B Common Stock may be transferred only to certain "Permitted Transferees" consisting generally of the lineal descendants of holders of Class B Common Stock, trusts for their benefit, corporations and partnerships controlled by them and the Company's employee benefit plans. Any transfer of Class B Common Stock in violation of these restrictions, including a transfer to the Company, results in the conversion of the transferred shares of Class B Common Stock held by the transferee into an equal number of shares of Class A Common Stock.

ITEM 2. EXHIBITS

All exhibits required by Instruction II to Item 2 will be supplied to the New York Stock Exchange.

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SIGNATURE

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized.

THE CATO CORPORATION

BY: /s/ John P. Derham Cato

NAME: JOHN P. DERHAM CATO
TITLE: PRESIDENT, VICE CHAIRMAN
AND CHIEF EXECUTIVE OFFICER

DATED: May 20, 2002

License Revenue. License revenue increased \$6.9 million, or 50%, during fiscal 2006 compared to fiscal 2005. This increase was due primarily to an increase in sales activity in our Human Capital Management

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products to new customers as well as additional licenses to existing customers, including customers gained through the Centra and THINQ acquisitions. In addition, license revenue from Centra was included from February 1, 2006. License revenue increased \$4.1 million, or 43%, during fiscal 2005 compared to fiscal 2004. This increase was primarily due to an increase in license revenue in the United States resulting from the expansion of our North American sales team in fiscal 2004.

License Updates and Product Support Revenue. License updates and product support revenue increased \$7.5 million, or 55%, during fiscal 2006 compared to fiscal 2005. This increase was primarily attributable to continued growth in our installed base, both organically as well as from the addition of the Centra and THINQ installed base of customers. License updates and product support revenue increased \$2.2 million, or 19%, during fiscal 2005 compared to fiscal 2004. The increase was due primarily to continued growth in our installed base of customers.

OnDemand Revenue. OnDemand revenue increased \$4.4 million, or 260%, during fiscal 2006 compared to fiscal 2005. The increase in OnDemand revenue was attributable to increased customer demand for these offerings from both existing customers and new customers, as well as the inclusion of Centra's OnDemand business from February 1, 2006. OnDemand revenue increased \$91,000, or 6%, during fiscal 2005 compared to fiscal 2004.

Professional Services Revenue. Professional services revenue increased \$10.2 million, or 77%, during fiscal 2006 compared to fiscal 2005. This increase was primarily due to an increase in implementation consulting services related to increased license sales, as well as consulting services provided to our expanded customer base, including the customers gained in the THINQ acquisition. Professional services revenue increased \$1.3 million, or 11%, during fiscal 2005 compared to fiscal 2004. This increase was primarily due to an increase in the number of active projects in fiscal 2005 as a result of an increase in the number of new license deals during the year.

International revenues as a percentage of total revenues and the mix of license and services revenues as a percentage of total revenues has varied significantly primarily due to variability in new license sales.

Cost of Revenues

	Years ended					
	Percent of		Percent of		Percent of	
	May 31, 2006	Total Revenues	May 31, 2005	Total Revenues	May 31, 2004	Total Revenues
	(dollars in thousands)					
Cost of revenues:						
Cost of license	\$ 733	1%	\$ 404	1%	\$ 222	1%
Cost of license updates and product support	4,714	6%	2,069	5%	1,674	5%
Cost of OnDemand	2,500	3%	809	2%	858	3%
Cost of professional services	16,797	24%	9,588	23%	9,525	27%
Amortization of acquired developed technology	393	1%		%	401	1%
Total cost of revenues	\$ 25,137	35%	\$ 12,870	31%	\$ 12,680	37%



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The following table is the summary of gross margin:

	Years ended May 31,		
	2006	2005	2004
	(in thousands, except percentages)		
Gross margin:			
License (including amortization of acquired developed technology)	\$ 19,537	\$ 13,390	\$ 9,042
<i>Percentage of license revenue</i>	95%	97%	94%
License updates and product support	16,344	11,495	9,716
<i>Percentage of license updates and product support revenue</i>	78%	85%	85%
OnDemand	3,585	880	740
<i>Percentage of OnDemand revenue</i>	59%	52%	46%
Professional services	6,544	3,575	2,293
<i>Percentage of professional services revenue</i>	28%	27%	19%
Total	\$ 46,010	\$ 29,340	\$ 21,791
<i>Percentage of total revenues</i>	65%	70%	63%

Total cost of revenues increased by \$12.3 million, or 95%, in fiscal 2006 when compared to fiscal 2005 and increased \$190,000, or 2%, in fiscal 2005 when compared to fiscal 2004.

Cost of License Revenue. Cost of license revenue includes the cost of manuals and product documentation, production media, shipping costs and royalties to third parties. Cost of license revenue increased \$329,000, or 81%, in fiscal 2006 when compared to fiscal 2005 and increased \$182,000, or 82%, in fiscal 2005 when compared to fiscal 2004. The increases in the cost of license revenue for fiscal 2006 compared to fiscal 2005 and for fiscal 2005 compared to fiscal 2004 were primarily attributable to the variability in the amount of royalties paid to third parties, in part due to the acquisitions of THINQ and Centra.

Cost of License Updates and Product Support Revenue. Cost of license updates and product support revenue includes salaries and related expenses for our license updates and product support organization. Cost of license updates and product support revenue increased \$2.6 million, or 128%, in fiscal 2006 compared to fiscal 2005. The increase was primarily due to the cost to support the license updates and product support contracts assumed in the THINQ and Centra acquisitions, as well as additional investment in our license updates and product support organization to support our growing customer base. Cost of license updates and product support revenue increased \$395,000, or 24%, in fiscal 2005 compared to fiscal 2004. The increase was due primarily to the investment in our license updates and product support organization to support our growing customer base. As a result of the increase in the cost of license updates and product support revenue, gross margin on license updates and product support declined from 85% in fiscal 2005 to 78% in fiscal 2006. The decline in gross margin on license updates and product support experienced during fiscal 2006 was the result of license update and product support contracts assumed in the THINQ and Centra acquisitions for which we incurred costs to provide the contracted services without all of the accompanying revenue as a result of GAAP purchase accounting adjustments, as well as the additional investment in the license updates and product support organization. Gross margin was constant at 85% in fiscal 2005 and 2004.

Cost of OnDemand Revenue. Cost of OnDemand revenue includes salaries and expenses related to the provision of the OnDemand offerings as well as external hosting fees and depreciation charges on the necessary infrastructure. Cost of OnDemand revenue increased by \$1.7 million, or 209%, in fiscal 2006 compared to fiscal 2005. The increase in cost of OnDemand revenue was primarily due to the additional headcount, third party co-location and connectivity fees and infrastructure costs associated with generating the additional OnDemand revenue. Cost of OnDemand revenue decreased by \$49,000, or 6%, in fiscal 2005 compared to fiscal 2004. The increases in gross margin experienced in fiscal

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2006 when compared to fiscal 2005 as well as the increase in gross margin from fiscal 2004 to fiscal 2005 were primarily the result of a growing user base.

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Cost of Professional Services Revenue. Cost of professional services revenue includes salaries and related expenses for our professional services, as well as third-party subcontractors and billed expenses. Cost of professional services revenue increased by \$7.2 million, or 75%, in fiscal 2006 compared to fiscal 2005 due primarily to the additional headcount and third party contractors required to drive the increased professional services revenue and to meet our customer demands. The increase in cost of services revenue in fiscal 2005 compared to fiscal 2004 of \$63,000, or 1%, was primarily attributable to an increase in consulting personnel expenses driven by an increase in professional services revenue in fiscal 2005.

Operating Expenses

We classify all operating expenses, except amortization of stock compensation charges, amortization of purchased intangible assets, in-process research and development and settlement of litigation, to the research and development, sales and marketing and general and administrative expense categories based on the nature of the expenses. Each of these three categories includes commonly recurring expenses such as salaries, employee benefits, travel and entertainment costs, and allocated communication, rent and depreciation costs. We allocate these expenses to each of the functional areas that derive a benefit from such expenses based upon their respective headcounts. The sales and marketing category of operating expenses also includes sales commissions and expenses related to public relations and advertising, trade shows, and marketing collateral materials. The general and administrative category of operating expenses also includes allowances for doubtful accounts and administrative and professional services fees.

	Years ended					
	Percent of		Percent of		Percent of	
	May 31, 2006	Total Revenues	May 31, 2005	Total Revenues	May 31, 2004	Total Revenues
	(dollars in thousands)					
Operating expenses:						
Research and development	\$ 14,107	20%	\$ 9,349	22%	\$ 9,972	29%
Sales and marketing	28,692	40%	17,520	42%	17,947	52%
General and administrative	7,532	11%	5,499	13%	4,357	13%
In-process research and development	760	1%		%		%
Amortization of purchased intangible assets	1,298	2%	51	%	139	%
Amortization of deferred compensation and other stock compensation charges		%		%	45	%
Settlement of litigation		%		%	1,701	5%
Total operating expenses	\$ 52,389	74%	\$ 32,419	77%	\$ 34,161	99%

Research and development. Research and development expenses increased \$4.8 million or 51% during fiscal 2006 compared to fiscal 2005, due primarily to an increase in employee related salary and benefit expenses and engineering services provided by third party consultants to support the growth in our HCM product suite, as well as products acquired in the Centra acquisition. The increase in employee related salary and benefit expenses included the additional headcount from Centra from the date of acquisition and from THINQ for the full fiscal year. Research and development expenses decreased \$0.6 million or 6% during fiscal 2005 compared to fiscal 2004, due primarily to a decrease in employee related costs as a result of reallocating headcount from the United States to our lower cost development center in India.

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Sales and marketing. Sales and marketing expenses increased by \$11.2 million or 64% during fiscal 2006 compared to fiscal 2005, primarily attributable to the increase in employee related salary and benefit expenses due to an increase in headcount of 51 primarily from the Centra acquisition, an increase in sales commissions on additional revenue, increases in travel related expenses and recruiting fees related to new hires not associated

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with acquisitions. During fiscal 2006, Saba focused on increasing its worldwide sales and marketing presence, including brand marketing and marketing events. During fiscal 2005, sales and marketing expenses decreased \$427,000 or 2% compared to fiscal 2004 due primarily to decreases in travel and entertainment expenses and other personnel related costs of \$160,000 and facilities costs of \$460,000. These costs were partially offset by an increase in marketing related programs and services of \$240,000.

General and administrative. General and administrative expenses increased \$2.0 million or 37% during fiscal 2006 compared to fiscal 2005, due primarily to an increase in salaries and related benefits resulting from an increase in headcount and an increase in outside service provider fees, including accounting and legal, due primarily to post-acquisition services required as a result of the THINQ and Centra acquisitions, the restructure of certain facilities that were deemed excess as a result of the THINQ and Centra acquisitions and compliance with our corporate governance initiatives, including those required under the Sarbanes-Oxley Act of 2002. Depending on our market capitalization on November 30, 2006, we will be required to comply with Section 404 of the Sarbanes-Oxley Act for either the fiscal year ended May 31, 2007 or May 31, 2008. We anticipate the cost of assessing our controls and performing other documentation and testing in accordance with Section 404 will be significant and will have a material impact on our general and administrative expenses for whichever year we will be required to comply with Section 404. The increase in salaries and related benefits included the additional headcount from Centra from the date of acquisition and from THINQ for full fiscal year. General and administrative expenses increased \$1.1 million, or 26%, during fiscal 2005 compared to fiscal 2004. Accounting and tax-related fees increased approximately \$687,000 due in part to \$253,000 of third-party consulting costs for Sarbanes-Oxley compliance and \$425,000 of audit and tax services fees for the year in part attributable to the THINQ acquisition. In addition, bad debt expense of \$153,000 in fiscal 2005 represents an increase of \$338,000 from fiscal 2004 due to a net credit in 2004 of \$185,000. Facilities-related costs also increased by approximately \$160,000.

Amortization of purchased intangible assets. Amortization of purchased intangible assets increased by \$1.2 million in fiscal 2006 compared to fiscal 2005, primarily due to the Centra and THINQ acquisitions. In fiscal 2005, we amortized \$49,000 of purchased intangibles related to customer relationships as a result of our May 2005 acquisition of THINQ. In addition, we amortized the remaining \$2,000 related to the March 2001 acquisition of Human Performance Technologies, Inc. Future amortization expense over each of the next five years is currently expected to range from \$4.0 million in fiscal 2007 through \$3.3 million in fiscal 2011. We periodically review our intangible assets and the estimated remaining useful lives of our intangible assets for impairment. Any impairment or reduction in our estimate of remaining useful lives could result in increased amortization expense in future periods.

Amortization of deferred stock compensation and other stock compensation charges. During fiscal 2004, we amortized our remaining deferred stock compensation of \$45,000. There was no amortization of deferred stock compensation and other stock compensation charges in fiscal 2006 or fiscal 2005.

Settlement of litigation. In September 2003, we settled pending patent litigation and recorded a charge of \$1.7 million. Under the terms of the settlement agreement, we were required to pay \$1.1 million over nine months. The remaining balance of \$375,000 at May 31, 2004 was paid in full during June 2004. In addition, we issued approximately 134,000 shares of our common stock valued at \$576,000 as of the settlement date.

Table of Contents**Restructuring charges**

During fiscal 2006, we implemented a restructuring program to consolidate excess facilities as a result of our acquisitions of THINQ and Centra. The restructuring program was implemented under the provisions of SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. During fiscal 2004, we implemented restructuring programs to reduce expenses to align our operations and cost structure with market conditions. The restructuring programs during fiscal 2004 were implemented under the provisions of SFAS No. 146. The restructuring charges are classified in the statement of operations as follows:

	Years ended May 31,		
	2006	2005	2004
	(in thousands)		
Cost of revenues	\$	\$	\$ 154
Research and development			166
Sales and marketing			73
General and administrative	358	(32)	39
Total	\$ 358	\$ (32)	\$ 432

During 2006, the facilities restructuring charges of \$358,000 were based on the present value of the sum of non-cancelable lease costs, less estimates for future sublease income, which will be paid over the estimated vacancy periods through fiscal 2008. During fiscal 2005, we reduced our facilities restructuring reserve for \$32,000 as a result of an amendment to a sub-tenant agreement. During fiscal 2004, the net restructuring charges of \$432,000 were comprised of \$473,000 for excess facilities and a reduction to a prior year workforce reduction accrual of \$41,000 that resulted from severance payments that were less than previous estimates.

Interest income and other, net

Interest income and other, net consists of interest income and other non-operating expenses, including foreign currency exchange gains or losses. Interest income and other, net increased to income of \$164,000 in fiscal 2006 compared to a net expense of \$12,000 in fiscal 2005. The increase was primarily due to the resulting interest income from higher average cash balances during fiscal 2006. Interest income and other, net was a net expense of \$12,000 in fiscal 2005 compared to a net expense of \$101,000 in fiscal 2004. The decrease in net expense in fiscal 2005 compared to 2004 was due primarily to a decrease in foreign exchange losses resulting from favorable fluctuations in foreign currency denominated receivables and an increase in interest income in fiscal 2005.

Interest expense

Interest expense was \$431,000 in fiscal 2006, \$77,000 in fiscal 2005 and \$104,000 in fiscal 2004. The increase in interest expense during fiscal 2006 compared to fiscal 2005 was primarily due to the interest related to the average debt outstanding under the bank credit facility during fiscal 2006. The decrease in interest expense in fiscal 2005 compared to fiscal 2004 was due to a decrease in average debt outstanding in during fiscal 2005.

Provision for income taxes

From inception to May 31, 2006, we incurred net losses for federal and state tax purposes. We recorded income tax expense of \$285,000 in fiscal 2006, \$248,000 in fiscal 2005 and \$108,000 in fiscal 2004. Income tax expense has consisted entirely of foreign income tax expense incurred as a result of local country profits.

The tax returns of one of the Company's subsidiaries are currently under examination. The Company has concluded that it is probable that the examination will result in an additional liability. We believe that adequate tax provisions have been provided for the likely outcome of the ongoing examination. We will continually review our estimates related to our income tax obligations, including potential assessments of additional taxes, penalties

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and/or interest, and revise our estimates, if deemed necessary. A revision in our estimates of our tax obligations will be reflected as an adjustment to our income tax provision at the time of the change in our estimates. Such a revision could materially impact our income tax provision and net income.

The Company has recorded a valuation allowance for the full amount of the net deferred tax assets, as it is more likely than not that the deferred tax assets will not be realized.

QUARTERLY RESULTS OF OPERATIONS

The following table sets forth condensed consolidated statement of operations data for each of the eight quarters in the period ended May 31, 2006. This information has been derived from our unaudited condensed consolidated financial statements that, in the opinion of management, include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of this information. You should read this information in conjunction with our audited consolidated financial statements and related notes appearing elsewhere in this Annual Report on Form 10-K. We have experienced and expect to continue to experience fluctuations in operating results from quarter to quarter. We have incurred net losses in each quarter since inception and expect to continue to incur losses in the foreseeable future. You should not draw any conclusions about our future results from the results of operations for any quarter, as quarterly results are not necessarily indicative of results for a full fiscal year or any other period.

	Three months ended							
	May 31, 2006	Feb 28, 2006	Nov 30, 2005	Aug 31, 2005	May 31, 2005	Feb 28, 2005	Nov 30, 2004	Aug 31, 2004
	(in thousands, except per share data)							
Revenues:								
License	\$ 6,124	\$ 6,019	\$ 5,124	\$ 3,396	\$ 4,196	\$ 3,758	\$ 3,318	\$ 2,522
License updates and product support	6,864	5,170	4,652	4,372	3,678	3,381	3,140	3,365
OnDemand	3,039	1,510	752	784	521	423	413	332
Professional Services	7,014	5,547	5,704	5,076	3,627	2,976	3,466	3,094
Total revenues	23,041	18,246	16,232	13,628	12,022	10,538	10,337	9,313
Cost of revenues	8,231	6,066	5,539	5,301	3,595	2,938	3,241	3,096
Gross profit	14,810	12,180	10,693	8,327	8,427	7,600	7,096	6,217
Operating expenses:								
Research and development	5,036	3,488	2,825	2,758	2,152	2,417	2,415	2,365
Sales and marketing	9,877	7,252	6,093	5,470	4,745	4,309	4,129	4,337
General and administrative	2,670	2,093	1,337	1,432	1,955	1,228	1,184	1,132
In-process research and development		760						
Amortization of purchased intangible assets	633	325	170	170	51			
Total operating expenses	18,216	13,918	10,425	9,830	8,903	7,954	7,728	7,834
(Loss) income from operations	(3,406)	(1,738)	268	(1,503)	(476)	(354)	(632)	(1,617)
Interest income (expense) and other, net	95	(140)	(111)	(111)	12	(73)	(10)	(18)

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(Loss) income before provision for income taxes	(3,311)	(1,878)	157	(1,614)	(464)	(427)	(642)	(1,635)
Provision for income taxes	(185)	(66)	(26)	(8)	(108)	(58)	(40)	(42)
Net (loss) income	\$ (3,496)	\$ (1,944)	\$ 131	\$ (1,622)	\$ (572)	\$ (485)	\$ (682)	\$ (1,677)
Basic and diluted net (loss) income per share	\$ (0.12)	\$ (0.09)	\$ 0.01	\$ (0.09)	\$ (0.03)	\$ (0.03)	\$ (0.04)	\$ (0.12)
Shares used in computing basic net (loss) income per share	28,059	20,674	17,523	17,295	16,483	16,146	16,107	14,026
Shares used in computing diluted net (loss) income per share	28,059	20,674	18,082	17,295	16,483	16,146	16,107	14,026

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Our results of operations could vary significantly from quarter to quarter. If revenues fall below our expectations, we will not be able to reduce our spending rapidly in response to the shortfall and operating losses will increase. We anticipate that we will continue to experience long sales cycles. Therefore, the timing of future customer contracts could be difficult to predict, making it difficult to estimate revenues between quarters.

We are subject to employer payroll taxes, both domestic and foreign, on employee exercises of non-qualified stock options. These taxes are recorded as a charge to operations in the period such options are exercised based on actual gains realized by employees, measured by the difference between the price of our common stock on the date of exercise and the exercise price. We receive domestic tax deductions for gains realized by domestic employees on the exercise of non-qualified stock options for which the benefit is recorded as additional paid-in capital when realized. Our taxes and cash flows could vary significantly from quarter to quarter depending on the number of non-qualified stock options exercised by employees in any quarter and, consequently, our results of operations could be adversely impacted.

Other factors that could affect our quarterly operating results include those described under the caption Item: 1A *Risk Factors* and below:

dependence of our revenues on a small number of large orders and the average order value;

our ability to attract new customers;

any changes in revenue recognition rules and interpretations of these rules;

our ability to license additional products to current customers;

the announcement or introduction of new products or services by us or our competitors;

changes in the pricing of our products and services or those of our competitors;

variability in the mix of our products and professional services revenues and the mix of new orders for our license and OnDemand revenues in any quarter;

technical difficulties or service interruptions of our computer network systems or the Internet generally;

the amount and timing of operating costs and capital expenditures relating to expansion or contraction of our business;

foreign currency fluctuations; and

acquisitions.

LIQUIDITY AND CAPITAL RESOURCES

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As of May 31, 2006, our principal source of liquidity included cash and cash equivalents of \$23.0 million. At May 31, 2006, our bank facility covenants required us to maintain cash, net of the outstanding term debt, of \$6.0 million on a monthly basis.

	Years ended May 31,		
	2006	2005	2004
Cash provided by (used in) operating activities	\$ 93	\$ (7,318)	\$ (7,194)
Cash provided by (used in) investing activities	7,121	(148)	3,203
Cash provided by financing activities	407	6,246	3,053

Cash Provided By (Used In) Operating Activities

Our most significant source of operating cash flows stems from customer purchases of our license, license updates and product support, OnDemand and professional services. Our primary uses of cash from operating activities are for personnel and facilities related expenditures. Cash provided by operating activities was \$93,000

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in fiscal 2006 compared to cash used of \$7.3 million in fiscal 2005. The increase is primarily a result of changes in operating assets and liabilities providing \$3.6 million and non-cash charges of \$3.5 million offset by a higher net loss of \$6.9 million for the year. The primary sources of the increase in fiscal 2006 were increases in deferred revenues of \$5.8 million and accounts receivables of \$0.4 million as a result of increased billings in fiscal 2006, particularly in the fourth quarter of fiscal 2006 due to the addition of Centra and an increase in accounts payable of \$2.0 million, partially offset by decreases in accrued expenses and accrued compensation and related expenses of \$4.9 million in fiscal 2006. Non-cash expenses, such as amortization of intangibles, write-off of in-process research and development and depreciation, increased to \$3.5 million in fiscal 2006 from \$0.7 million in fiscal 2005.

Cash used in operating activities was \$7.3 million in fiscal 2005 compared to \$7.2 million in fiscal 2004, representing a 2% increase. The increase is primarily a result of greater movements in operating assets and liabilities of \$4.6 million offset by a lower net loss of \$3.4 million for the year as we reduced overall expenses before non-cash items such as amortization of intangibles, stock compensation and depreciation by approximately \$1.5 million and increased our revenues by approximately \$7.7 million in fiscal 2005. Net movements on operating assets and liabilities used approximately \$4.7 million of cash in fiscal 2005 compared to net movements that provided \$2.7 million in cash during fiscal 2004. The primary sources of this decrease in fiscal 2005 were increases in receivables of \$3.4 million as a result of increased revenues in fiscal 2005, particularly in the latter part of the fourth quarter of fiscal 2005, and decreases in accrued and accrued compensation and related expenses of \$1.4 million in fiscal 2005.

Cash Provided By (Used In) Investing Activities

Cash provided by investing activities of \$7.1 million in fiscal 2006 was primarily attributable to the net cash acquired through the acquisition of Centra of \$8.3 million offset by purchases of property and equipment of approximately \$1.2 million. Cash used in investing activities in fiscal 2005 was primarily attributable to the purchases of property and equipment of approximately \$249,000 offset by maturities of short-term investments of \$150,000. Cash provided by investing activities in fiscal 2004 was primarily attributable to proceeds from redemptions and maturities of short-term investments, net of purchases, of \$3.5 million.

Cash Provided By Financing Activities

Cash provided by financing activities decreased in fiscal 2006 by \$5.8 million compared to fiscal 2005 due primarily to the first quarter of fiscal 2005 private placement of common stock of \$8.6 million, partially offset by lower net repayments of borrowings under our credit facilities and equipment term loans of approximately \$0.6 million in fiscal 2006 compared to \$2.7 million during fiscal 2005. Cash provided by financing activities increased by \$3.2 million in fiscal 2005 compared to fiscal 2004 due primarily to higher proceeds from the issuance of common stock that included \$8.6 million in a private placement in the first quarter of fiscal 2005. This increase was partially offset by net repayments of borrowings under our credit facilities and equipment term loans of \$2.7 million during fiscal 2005 compared to net borrowings under our credit facilities and equipment term loans of \$2.9 million in fiscal 2004.

Contractual Obligations and Commitments

As of May 31, 2006, we did not have any material commitments for capital leases. Our principal commitment consisted of obligations under operating leases and our credit facility. On January 31, 2006, the Company entered into a new credit facility with a bank. The credit facility replaces the Company's existing credit facility with the bank. The credit facility provides for (i) a term loan in a principal amount of \$6,500,000, and (ii) a receivables borrowing base revolving credit line in an aggregate principal amount of up to \$7,500,000, which includes a sub-limit of up to \$5,000,000 for letters of credit, cash management and foreign exchange services. The term loan will be repaid in 36 equal monthly

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installments of principal, plus interest. The maturity date of the term loan and the revolving credit line is January 31, 2009. The interest rate applicable to the loans

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under the credit facility is the bank's prime rate plus 0.50% for the term loan and the bank's prime rate plus 0.25% for borrowings under the revolving credit line. The Company is required to pay an early termination fee if the credit facility is terminated by the bank due to the occurrence of an event of default or is refinanced by another financial institution, in each case, prior to the second anniversary of the credit facility. As of May 31, 2006, the Company had borrowings on the credit facility of \$6.0 million.

The credit facility is secured by all of the Company's personal property other than its intellectual property. The credit facility includes certain negative covenants restricting or limiting the ability of the Company and its subsidiaries to, among other things: incur additional indebtedness; create liens on its property; make certain investments and acquisitions; merge or consolidate with any other entity; convey, sell, lease, transfer or otherwise dispose of assets; change its business; experience a change of control; pay dividends, distributions or make other specified restricted payments; and enter into certain transactions with affiliates. Such restrictions and limitations are subject to usual and customary exceptions contained in credit agreements of this nature. In addition, the credit facility requires the Company to satisfy a minimum consolidated EBITDA covenant on a quarterly basis, and a minimum liquidity covenant on a monthly basis. EBITDA, or earnings before income tax, depreciation and amortization, also excludes stock-based compensation and includes the estimated revenue that would have been recorded related to the Centra deferred revenue fair value adjustment. As of May 31, 2006, the Company was in compliance with all covenants. If we violate any of these restrictive covenants or otherwise breach the credit facility agreement, the Company may be required to repay the obligations under the credit facility prior to their stated maturity date, the Company's ability to borrow under the revolving credit line may be terminated and the bank may be able to foreclose on any collateral provided by the Company.

The following table summarizes our contractual obligations at May 31, 2006 and the effect these obligations are expected to have on our liquidity and cash flows in future periods. Of the \$26.8 million in operating leases, \$503,000, which is net of estimated sublease income of \$550,000, is included in accrued restructuring charges as of May 31, 2006.

	Payments due by period						
	Total	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	Thereafter
Contractual obligations:							
Long-Term debt obligations	\$ 6,292	\$ 2,330	\$ 2,247	\$ 1,694	\$ 21	\$	\$
Operating lease obligations	26,766	4,144	3,916	2,608	2,729	2,613	10,756
Other long-term liabilities	1,100	655	130	105	105	105	
Total	\$ 34,158	\$ 7,129	\$ 6,293	\$ 4,407	\$ 2,855	\$ 2,718	\$ 10,756

As of May 31, 2006, we did not have any significant purchase obligations for goods or services that are enforceable and legally binding.

We currently anticipate that our available cash resources and credit facility, 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. However, we may be required, or could choose, to raise additional funds at any time. Our future liquidity and capital requirements will depend on numerous factors, including our future revenues, the timing and extent of spending to support product development efforts and expansion of sales and marketing and general and administrative activities, the success of our existing and new product and service offerings and competing technological and market developments. There can be no assurance that additional funding, if needed, will be available on terms acceptable to us, if at all.

Off-Balance Sheet Arrangements

As of May 31, 2006, we did not have any off-balance sheet arrangements as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

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ITEM 7A: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

Our exposure to market risk for changes in interest rates relates primarily to our borrowings and investments. On January 31, 2006, the Company entered into a new credit facility with a bank. The credit facility provides for (i) a term loan in a principal amount of \$6,500,000, and (ii) a receivables borrowing base revolving credit line in an aggregate principal amount of up to \$7,500,000, which includes a sub-limit of up to \$5,000,000 for letters of credit, cash management and foreign exchange services. The term loan will be repaid in 36 equal monthly installments of principal, plus interest. The maturity date of the term loan and the revolving credit line is January 31, 2009. The interest rate applicable to the loans under the credit facility is the bank's prime rate plus 0.50% for the term loan and the bank's prime rate plus 0.25% for borrowings under the revolving credit line. The Company is required to pay an early termination fee if the credit facility is terminated by the bank due to the occurrence of an event of default or is refinanced by another financial institution, in each case, prior to the second anniversary of the credit facility.

The credit facility is secured by all of the Company's personal property other than its intellectual property. The credit facility includes certain negative covenants restricting or limiting the ability of the Company and its subsidiaries to, among other things: incur additional indebtedness; create liens on its property; make certain investments and acquisitions; merge or consolidate with any other entity; convey, sell, lease, transfer or otherwise dispose of assets; change its business; experience a change of control; pay dividends, distributions or make other specified restricted payments; and enter into certain transactions with affiliates. Such restrictions and limitations are subject to usual and customary exceptions contained in credit agreements of this nature. In addition, the credit facility requires the Company to satisfy a minimum consolidated EBITDA covenant on a quarterly basis, and a minimum liquidity covenant on a monthly basis. EBITDA, or earnings before income tax, depreciation and amortization, also excludes stock-based compensation and includes the estimated revenue that would have been recorded related to the Centra deferred revenue fair value adjustment.

The credit facility also contains usual and customary events of default (subject to certain threshold amounts and grace periods). If an event of default occurs and is continuing, the Company may be required to repay the obligations under the credit facility prior to their stated maturity date, the Company's ability to borrow under the revolving credit line may be terminated, and the bank may be able to foreclose on any collateral provided by the Company.

As of May 31, 2006, we had \$6.0 million outstanding under the term loan, no outstanding borrowings under the receivables borrowing base revolving credit line and were in compliance with all of the covenants related to this credit facility.

At May 31, 2006, we had cash and cash equivalents totaling \$23.0 million. Of this amount, approximately \$17.4 million was invested in money market accounts bearing variable interest rates of between 0.50% and 6.50%. The remainder of our cash and cash equivalents is held in non-interest bearing accounts at several banks. Variable interest rate securities may produce less income than expected if interest rates fall. A 0.5% change in interest rates would not be significant.

Foreign Currency Risk

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We do not use derivative instruments to manage risks associated with foreign currency transactions in order to minimize the impact of changes in foreign currency exchange rates on earnings. We provide our products and services to customers in the United States, Europe and elsewhere throughout the world. Sales are primarily made in U.S. dollars, and to a lesser but increasing extent, British pounds and Euros; however, as we continue to expand our operations, more of our contracts may be denominated in Australian dollars, Canadian dollars and Japanese yen. A strengthening of the U.S. dollar could make our products less competitive in foreign markets.

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Our exposure to foreign exchange rate fluctuations also arises in part from inter-company accounts with our foreign subsidiaries. These inter-company accounts are typically denominated in the functional currency of the foreign subsidiary, and, when re-measured and translated in U.S. dollars, have an impact on our operating results depending upon the movement in foreign currency rates. During fiscal 2006, our total realized and unrealized losses due to movements in foreign currencies, primarily British pounds and Australian dollars, was \$171,000. As exchange rates vary, these foreign exchange results may vary and adversely or favorably impact operating results. An unfavorable change of 10% in foreign currency rates would not have a material impact on our financial statements.

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ITEM 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

SABA SOFTWARE, INC.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of Saba Software, Inc.

We have audited the accompanying consolidated balance sheets of Saba Software, Inc. as of May 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended May 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Saba Software, Inc. at May 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended May 31, 2006, in conformity with U.S. generally accepted accounting principles.

/s/ Ernst & Young LLP

San Jose, California

August 18, 2006

Table of Contents**SABA SOFTWARE, INC.****CONSOLIDATED BALANCE SHEETS**

(in thousands, except share and per share data)

	<u>May 31,</u>	
	<u>2006</u>	<u>2005</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 23,029	\$ 15,408
Restricted cash	500	140
Accounts receivable (net of allowance of \$114 at May 31, 2006 and \$329 at May 31, 2005)	18,993	15,187
Prepaid expenses and other current assets	2,709	1,543
	<u>45,231</u>	<u>32,278</u>
Total current assets	45,231	32,278
Property and equipment, net	2,172	874
Goodwill	38,164	15,164
Purchased intangible assets, net	20,449	4,993
Other assets	1,018	990
	<u>107,034</u>	<u>54,299</u>
Total assets	\$ 107,034	\$ 54,299
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 8,782	\$ 4,975
Accrued compensation and related expenses	6,259	2,969
Accrued expenses	6,265	4,529
Deferred revenue	24,230	12,406
Current portion of debt and lease obligations	2,330	2,300
	<u>47,866</u>	<u>27,179</u>
Total current liabilities	47,866	27,179
Deferred revenue	526	51
Accrued rent	2,833	2,839
Debt and lease obligations, less current portion	3,962	3,396
	<u>55,187</u>	<u>33,465</u>
Total liabilities	55,187	33,465
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, issuable in series: \$0.001 par value: 5,000,000 authorized shares at May 31, 2006 and 2005; none issued or outstanding		
Common stock, \$0.001 par value: 50,000,000 authorized; 28,509,483 and 17,987,247 shares issued at May 31, 2006 and 2005		
	29	18
Additional paid-in capital	247,716	209,621
Treasury stock: 102,997 shares at May 31, 2006 and 2005, at cost	(232)	(232)
Accumulated deficit	(195,359)	(188,428)
Accumulated other comprehensive loss	(307)	(145)
	<u>29</u>	<u>18</u>

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Total stockholders' equity	51,847	20,834
Total liabilities and stockholders' equity	\$ 107,034	\$ 54,299

See accompanying Notes to Consolidated Financial Statements.

Table of Contents**SABA SOFTWARE, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share data)**

	Years ended May 31,		
	2006	2005	2004
Revenues:			
License	\$ 20,663	\$ 13,794	\$ 9,665
License updates and product support	21,058	13,564	11,390
OnDemand	6,085	1,689	1,598
Professional services	23,341	13,163	11,818
Total revenues	71,147	42,210	34,471
Cost of revenues:			
Cost of license	733	404	222
Cost of license updates and product support	4,714	2,069	1,674
Cost of OnDemand	2,500	809	858
Cost of professional services	16,797	9,588	9,525
Amortization of acquired developed technology	393		401
Total cost of revenues	25,137	12,870	12,680
Gross profit	46,010	29,340	21,791
Operating expenses:			
Research and development	14,107	9,349	9,972
Sales and marketing	28,692	17,520	17,947
General and administrative	7,532	5,499	4,357
In-process research and development	760		
Amortization of purchased intangible assets	1,298	51	139
Amortization of deferred stock compensation and other stock charges			45
Settlement of litigation			1,701
Total operating expenses	52,389	32,419	34,161
Loss from operations	(6,379)	(3,079)	(12,370)
Interest income and other, net	164	(12)	(101)
Interest expense	(431)	(77)	(104)
Loss before provision for income taxes	(6,646)	(3,168)	(12,575)
Provision for income taxes	(285)	(248)	(108)
Net loss	\$ (6,931)	\$ (3,416)	\$ (12,683)
Basic and diluted net loss per share	\$ (0.33)	\$ (0.22)	\$ (0.95)

Shares used in computing basic and diluted net loss per share	20,898	15,687	13,411
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See accompanying Notes to Consolidated Financial Statements.

Table of Contents**SABA SOFTWARE, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

(in thousands, except share data)

	Preferred Stock		Common Stock			Treasury Stock		Accumulated		Total Stockholders Equity	
	Shares	Amount	Shares	Amount	Additional Paid in Capital	Shares	Amount	Accumulated Deficit	Other Comprehensive Income (loss)		
Balance at May 31, 2003		\$	13,328,680	\$ 13	\$ 191,281	\$ (45)	(102,578)	\$ (232)	\$ (172,329)	\$ (228)	\$ 18,460
Repurchase of common stock							(419)				
Issuance of common stock under employee stock purchase plan			22,391	1	75						76
Issuance of common stock in connection with exercise of stock options, net of repurchases			19,291		33						33
Issuance of common stock for settlement of litigation			134,055		576						576
Amortization of deferred stock compensation						45					45
Net loss								(12,683)			(12,683)
Unrealized loss on investment									(5)		(5)
Foreign currency translation adjustments									19		19
Comprehensive loss											(12,669)
Balance at May 31, 2004			13,504,417	14	191,965		(102,997)	(232)	(185,012)	(214)	6,521
Issuance of common stock under employee stock purchase plan			51,244		151						151
Issuance of common stock in connection with exercise of stock options			57,086		163						163
Issuance of common stock			2,674,500	2	8,626						8,628
Issuance of common stock in connection with the acquisition of THINQ			1,700,000	2	8,716						8,718
Net Loss								(3,416)			(3,416)
Foreign currency translation adjustments									69		69
Comprehensive loss											(3,347)
Balance at May 31, 2005		\$	17,987,247	\$ 18	\$ 209,621	\$	(102,997)	\$ (232)	\$ (188,428)	\$ (145)	\$ 20,834

See accompanying Notes to Consolidated Financial Statements.

Table of Contents**SABA SOFTWARE, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY (CONTINUED)**

(in thousands, except share data)

	<u>Preferred Stock</u>		<u>Common Stock</u>			<u>Treasury Stock</u>		<u>Accumulated</u>		<u>Total Stockholders Equity</u>
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>	<u>Additional Paid in Capital</u>	<u>Deferred Compensation</u>	<u>Shares</u>	<u>Amount</u>	<u>Accumulated Deficit</u>	
Balance at May 31, 2005		\$ 17,987,247	\$ 18	\$ 209,621	\$	(102,997)	\$ (232)	\$ (188,428)	\$ (145)	\$ 20,834
Issuance of common stock under employee stock purchase plan		56,121		182						182
Issuance of common stock in connection with exercise of stock options		233,098	1	792						793
Issuance of common stock in connection with the acquisition of Centra		10,367,406	10	37,810						37,820
Cancellation of escrow shares from the acquisition of THINQ		(134,389)		(689)						(689)
Net loss								(6,931)		(6,931)
Foreign currency translation adjustments									(162)	(162)
Comprehensive loss										(7,093)
Balance at May 31, 2006		\$ 28,509,483	\$ 29	\$ 247,716	\$	(102,997)	\$ (232)	\$ (195,359)	\$ (307)	\$ 51,847

See accompanying Notes to Consolidated Financial Statements.

Table of Contents**SABA SOFTWARE, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)**

	Years ended May 31,		
	2006	2005	2004
Operating activities:			
Net loss	\$ (6,931)	\$ (3,416)	\$ (12,683)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	833	647	1,618
Amortization of purchased intangible assets	1,864	59	139
Amortization of acquired developed technology			401
Write-off of in-process research and development	760		
Amortization of deferred stock compensation			45
Expense for common stock issued for settlement of litigation			576
Loss on disposal of property and equipment	8		
Changes in operating assets and liabilities:			
Accounts receivable	372	(3,356)	2,686
Prepaid expenses and other current assets	(272)	(465)	188
Other assets	108	117	(8)
Accounts payable	2,020	266	(88)
Accrued compensation and related expenses	456	412	(166)
Accrued expenses	(4,955)	(1,963)	391
Deferred revenue	5,837	61	(84)
Accrued rent	(7)	320	(148)
Other long-term liabilities			(61)
Net cash provided by (used in) operating activities	93	(7,318)	(7,194)
Investing activities:			
Proceeds from redemption and maturities of short-term investments	40	150	3,476
Purchases of property and equipment	(1,235)	(249)	(273)
Cost of acquisitions, net of cash acquired	8,316	(49)	
Net cash provided by (used in) investing activities	7,121	(148)	3,203
Financing activities:			
Proceeds from issuance of common stock under employee stock plans	975	314	109
Proceeds from issuance of common stock, net of issuance costs		8,626	
Principal payments under capital lease obligations		(37)	(35)
Borrowings under credit facility, net of issuance costs	6,624	4,813	14,093
Repayments on borrowings under the credit facility	(7,227)	(6,704)	(11,044)
Repayments on equipment term loans	(58)	(696)	
Borrowings under equipment term loans	163		
Repayments on note payable	(70)	(70)	(70)
Net cash provided by financing activities	407	6,246	3,053
Increase (decrease) in cash and cash equivalents	7,621	(1,220)	(938)
Cash and cash equivalents, beginning of period	15,408	16,628	17,566
Cash and cash equivalents, end of period	23,029	15,408	16,628
Short-term investments, end of period			150

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Total cash, cash equivalents and short-term investments, end of period	\$ 23,029	\$ 15,408	\$ 16,778
Supplemental disclosure of non-cash transactions:			
Common stock issued for acquisitions, net of cancellations	\$ 37,131	\$ 8,718	\$
Supplemental disclosure of other cash flow information:			
Cash paid for income taxes, net of refunds	\$ 55	\$ 78	\$ 172
Cash paid for interest	\$ 392	\$ 73	\$ 104

See accompanying Notes to Consolidated Financial Statements.

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SABA SOFTWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. The Company

Saba Software, Inc. (Saba or the Company) is a provider of human capital management solutions, which are designed to help enterprises of all sizes increase organizational performance, understand and maximize the value of their people and manage people-related risks risks that include the aging workforce, the generational shift in the workforce and the increasingly competitive labor market and associated employee and executive turnover. With this intense competition for talent and the need to adapt quickly to changing markets, managing the workforce well is critical to an organization s ability to create sustainable competitive advantage.

The Company s solutions help its customers through the implementation of a management system for aligning goals, developing and motivating people and measuring results. By implementing the Company s solutions, organizations are better equipped to: align their workforce around the organization s business objectives; effectively manage growing regulatory requirements; increase sales and channel readiness; accelerate the productivity of new people joining the extended enterprise of employees, customers, partners, and suppliers; increase both the speed of customer acquisition and long-term customer loyalty; shorten time-to-market of new products; and improve visibility into organizational performance. To date, Saba Enterprise Learning and related services have accounted for a substantial majority of Saba s revenues. Saba anticipates that revenues from Saba Enterprise Learning and related services will continue to constitute a substantial majority of its revenues for the foreseeable future.

Saba sells its products and related services worldwide primarily through a direct sales force and alliance partners. The Company s corporate headquarters are located in Redwood Shores, California. In addition, the Company has international subsidiaries in India, France, Japan, Germany, the United Kingdom, Canada and Australia through which it conducts various operating activities related to its business. In each of the non-U.S. jurisdictions in which it has subsidiaries, other than India, Saba has employees or consultants engaged in sales and services activities. In the case of its India subsidiary, Saba s employees primarily engage in software development and quality assurance testing activities.

Saba was incorporated in the State of Delaware in April 1997.

2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of Saba and its wholly owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation. Certain previously reported amounts have been reclassified to conform to the current presentation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ materially from those estimates.

Cash, Cash Equivalents and Short-term Investments

Cash and cash equivalents consist of highly liquid short-term investments with insignificant interest rate risk and original maturities from the date of purchase of three months or less. Short-term investments are investments

Table of Contents**SABA SOFTWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

with maturities between 90 days and one year. Cash, cash equivalents and short-term investments are stated at fair value based on quoted market prices. In accordance with Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, management determines the appropriate classification of debt and equity securities at the time of purchase and re-evaluates the designation as of each balance sheet date. The Company had no short-term investments as of May 31, 2006 and 2005.

Fair Value of Financial Instruments

Carrying amounts of certain of Saba's financial instruments including cash, cash equivalents and accrued liabilities approximate fair value due to their short maturities. The carrying amount of Saba's note payable, debt and capital lease obligations approximate fair value based on the terms of similar borrowing arrangements available to Saba.

Trade Accounts Receivable and Concentrations of Credit Risk

Financial instruments that potentially subject Saba to concentrations of risk include cash, cash equivalents and accounts receivable. Management believes the financial risks associated with these financial instruments are minimal.

Saba conducts business with companies in various industries throughout the world. Trade accounts receivable are recorded at the invoiced amount, do not bear interest, and generally do not require collateral. Saba Enterprise Learning and related services have accounted for a substantial majority of Saba's revenues since inception. An allowance is maintained for potential credit issues, and to date, such losses have been within management's expectations. The allowance for doubtful accounts is based on Saba's assessment of the amount of probable credit losses in the existing accounts receivable. Saba determines the allowance based on the aging of the accounts receivable, the financial condition of its customers and their payment history, its historical write-off experience and other assumptions. Past due balances based on purchase order terms and other specific accounts as necessary are reviewed monthly. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The changes in the allowance for doubtful accounts are as follows:

	Beginning Balance	Additions charged to Operations	Write- Offs	Ending Balance
	_____	_____	_____	_____
	(in thousands)			
Year Ended:				
May 31, 2004	\$ 654		477	\$ 177
May 31, 2005	\$ 177	152		\$ 329
May 31, 2006	\$ 329	166	381	\$ 114

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At May 31, 2006, there were no customers accounting for more than 10% of Saba's accounts receivable balance. At May 31, 2005, the Company's accounts receivable included one customer that represented approximately 15% of the total balance.

Property and Equipment

Property and equipment are stated at cost and are depreciated using the straight-line method over the estimated useful lives of the related assets, which are generally three to five years. Assets acquired under capital

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SABA SOFTWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

lease obligations are amortized over the shorter of the estimated useful life of the asset or the life of the lease. Amortization expense for assets acquired under capital lease obligations is included with depreciation expense. Leasehold improvements are amortized over the shorter of the estimated useful lives of the assets or the life of the lease.

Purchased Intangible Assets and Goodwill

Purchased intangible assets consist of intellectual property, customer relationships, tradenames, and customer backlog acquired as part of a purchase business combination. The intangible assets are stated at cost less accumulated amortization and are being amortized on a straight-line basis over their estimated useful lives of two to seven years.

Goodwill represents the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired. Goodwill amounts are not amortized, but rather are tested for impairment at least annually. In the event that Saba determines that the value of goodwill has become impaired, the Company will incur an accounting charge for the amount of impairment during the fiscal quarter in which such determination is made. Goodwill is not deductible for income tax purposes.

Software Development Costs

Saba accounts for software development costs in accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed*, whereby costs for the development of new software products and substantial enhancements to existing software products are expensed as incurred until technological feasibility has been established, at which time any additional costs are capitalized. Technological feasibility is established upon completion of a working model. Through May 31, 2006, software development costs incurred subsequent to the establishment of technological feasibility have not been significant, and all software development costs have been charged to research and development expense in the accompanying consolidated statements of operations.

Income Taxes

Saba accounts for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*, which requires the use of the liability method. Under this method, deferred tax assets and liabilities are measured based on differences between financial reporting and tax bases of assets and liabilities measured using enacted tax rates and laws that are expected to be in effect when the differences are expected to reverse.

Stock Options and Equity Instruments Exchanged for Services

Saba accounts for employee stock options using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* while adhering to the disclosure requirements of SFAS No. 123, *Accounting for Stock-Based Compensation* and SFAS No. 148 *Accounting for Stock-Based Compensation Transition and Disclosure*. Saba accounts for stock options issued to non-employees for services or assets acquired using the provisions of Emerging Issues Task Force (EITF) Issue No. 96-18 *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. To calculate the expense or asset value, Saba uses either the fair value of the consideration received or the fair value of the equity instruments issued using the Black-Scholes-Merton option-pricing model, whichever is more reliably measured.

Pro forma information regarding net loss and net loss per share, which is required by SFAS No. 123, has been determined as if Saba had accounted for its employee stock options under the fair value method of SFAS

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SABA SOFTWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

No. 123. The fair value of options granted in fiscal 2006, fiscal 2005 and fiscal 2004 reported below has been estimated at the date of grant using a Black-Scholes-Merton option-pricing model with the following weighted-average assumptions:

	Years ended May 31,		
	2006	2005	2004
<i>Stock Option Plans:</i>			
Expected life (in years)	2.5	2.3	3.0
Risk-free interest rate	5.1%	3.4%	2.7%
Volatility	0.49	0.55	0.80
Dividend yield	0%	0%	0%

	Years ended May 31,		
	2006	2005	2004
<i>Employee Stock Purchase Plan:</i>			
Expected life (in years)	0.5	0.5	0.5
Risk-free interest rate	5.3%	3.7%	2.1%
Volatility	0.44	0.96	0.76
Dividend yield	0%	0%	0%

The weighted-average fair value of options granted for fiscal years 2006, 2005 and 2004 was \$3.23, \$2.85 and \$1.85, respectively.

The following table illustrates the effect on net loss and net loss per share had compensation cost for Saba's stock compensation plans been determined using the fair value method required by SFAS No. 123:

	Years ended May 31,		
	2006	2005	2004
	(in thousands,		
	except per share amounts)		
Net loss as reported	\$ (6,931)	\$ (3,416)	\$ (12,683)
Add: Total stock-based employee compensation expense included in net loss			45

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Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(6,362)	(7,758)	(11,983)
Adjusted net loss	(13,293)	(11,174)	(24,621)
Net loss per share as reported	(0.33)	(0.22)	(0.95)
Adjusted net loss per share	(0.64)	(0.71)	(1.84)

The pro forma impact of options on the net loss for fiscal 2006 is not representative of the effects on results of operations or loss for future years, as future years may include the effects of additional stock option grants.

Basic and Diluted Net Loss Per Share

Basic and diluted net loss per share information for all periods is presented under the requirements of SFAS No. 128, *Earnings per Share*. Basic earnings per share has been computed using the weighted-average number of shares of common stock outstanding during the period, less shares that may be repurchased, and excludes any dilutive effects of options, warrants and convertible securities.

Table of Contents**SABA SOFTWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The calculations of basic and diluted net loss per share are as follows:

	<u>Years ended May 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
	(in thousands,		
	except per share amounts)		
Net loss	\$ (6,931)	\$ (3,416)	\$ (12,683)
Weighted-average shares of common stock outstanding	20,898	15,687	13,436
Weighted-average shares of common stock subject to repurchase			(25)
	<u>20,898</u>	<u>15,687</u>	<u>13,411</u>
Weighted-average shares of common stock used in computing basic and diluted net loss per share	20,898	15,687	13,411
	<u>(0.33)</u>	<u>(0.22)</u>	<u>(0.95)</u>
Basic and diluted net loss per share	(0.33)	(0.22)	(0.95)

If Saba had reported net income, diluted net income per share would have included common equivalent shares related to outstanding options and warrants to purchase common stock not included above of 509,101, 332,557 and 238,347 at May 31, 2006, 2005 and 2004, respectively. The common equivalent shares from options and warrants would be determined using the treasury stock method. In addition, potentially dilutive stock options representing 1.7 million, 0.5 million and 1.0 million shares of common stock for the years ended May 31, 2006, 2005 and 2004, respectively, have been excluded from the computation of diluted net loss per share because they have exercise prices higher than the average stock price during the respective periods and their inclusion would be anti-dilutive under the treasury stock method.

Revenue Recognition

Saba recognizes revenues in accordance with the provisions of American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*. Under SOP 97-2, as amended, Saba recognizes revenues when all of the following conditions are met:

persuasive evidence of an agreement exists;

delivery has occurred;

the fee is fixed or determinable; and

collection is probable.

SOP 97-2, as amended, requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of the elements. Saba has analyzed each element in its multiple-element arrangements and determined that it has sufficient vendor-specific objective evidence (VSOE) to allocate revenues to certain OnDemand offerings, license updates and product support and professional services. Accordingly, assuming all other revenue recognition criteria are met, revenues from perpetual licenses are recognized upon delivery using the residual method in accordance with SOP 98-9. Saba limits its assessment of VSOE for each element to either the price charged when the same element is sold separately or the price established by management, having the relevant authority to do so, for an element not yet sold separately.

License revenues from licenses with a term of three years or more are generally recognized on delivery if the other conditions of SOP 97-2 are satisfied. Saba does not grant its resellers the right of return and does not recognize revenue from resellers until an end-user has been identified and the other conditions of SOP 97-2 are

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SABA SOFTWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

satisfied. License updates and product support revenue is also recognized ratably over the term of the arrangement, typically 12 months, and revenue related to professional services is generally recognized as the services are performed. Although Saba provides professional services on a time and materials basis, a significant portion of these services is provided on a fixed-fee basis. For contracts that involve significant customization and implementation or consulting services that are essential to the functionality of the software, the license and services revenues are recognized over the service delivery period using the percentage-of-completion method. Saba uses labor hours incurred as a percentage of total expected hours as the measure of progress towards completion.

Revenue from Saba's OnDemand offerings is recognized as a service arrangement whereby the revenue is recognized ratably over the term of the arrangement or on an as-used basis if defined in the contract. Certain of its OnDemand offerings are integrated offerings pursuant to which the customers' ability to access our software is not separable from the services necessary to operate the software and customers are not allowed to take possession of our software, in which case revenue is recognized under the SEC's Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*. Saba's OnDemand offerings also include arrangements with customers that have separately licensed and taken possession of our software. When these OnDemand offerings are part of a multiple element arrangement involving licenses, Saba recognizes revenue in accordance with SOP 97-2.

Accounts receivable includes amounts earned but unbilled of \$2.4 million and \$1.9 million at May 31, 2006 and 2005. Deferred revenue consists of prepaid or billed fees for services and support agreements and license fees to be recognized in future periods.

Advertising Expense

Advertising costs are expensed as incurred and recorded in sales and marketing. Saba incurred advertising costs of \$16,000, \$89,000 and \$71,000 in fiscal 2006, 2005 and 2004, respectively.

Foreign Currency Translation

In general, the functional currency of the Company's foreign subsidiaries is the local currency. Gains and losses resulting from translation of these foreign currency financial statements into U.S. dollars are recorded within stockholders' equity as part of accumulated other comprehensive income (loss).

Accumulated Other Comprehensive Loss

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Comprehensive loss is comprised of net loss and other comprehensive gain (loss) and is reported in the accompanying statement of stockholders equity. The components of accumulated other comprehensive loss are as follows (in thousands):

	<u>May 31,</u>	
	<u>2006</u>	<u>2005</u>
Foreign currency translation losses	(307)	(145)
Accumulated other comprehensive loss	<u>(307)</u>	<u>(145)</u>

Recent Accounting Pronouncements

On December 16, 2004 the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004) (SFAS No. 123R), *Share Based Payment, which is a revision of SFAS No. 123*. SFAS No. 123R will

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SABA SOFTWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

require that any share based payment to an employee, including grants of employee stock options and purchases under employee stock purchase plans, be recognized in the statement of operations based on their fair value. Pro forma disclosure of fair value recognition will no longer be an alternative. SFAS No. 123R is effective for the first annual beginning after June 15, 2005, and will be effective for the Company beginning in fiscal 2007.

On June 1, 2006, the Company will adopt SFAS No. 123R using the modified prospective method. The effects of the adoption of SFAS No. 123R on our results of operations and financial condition are dependent upon a number of factors, including the number of employee options which may be granted in the future, the future market value and volatility of our stock price, movements in the risk free rate of interest, stock option exercises and forfeiture patterns and the stock option valuation model used to estimate the fair value of each option. The adoption of SFAS No. 123R will have a significant impact on the Company's results of operations. The section within Note 2 entitled *Stock Options and Equity Instruments Exchanged for Services* provides an indication of the effects of using the Black-Scholes-Merton option pricing model using the assumptions detailed therein to estimate the fair value of employee stock options and employee stock purchase plan options upon the results of operations for the 12 months ended May 31, 2006, 2005 and 2004.

In March 2005, the SEC issued Staff Accounting Bulletin (SAB) 107, *Share-Based Payment*. SAB 107 provides guidance regarding the interaction between SFAS No. 123R and certain SEC rules and regulations, including guidance related to valuation methods, the classification of compensation expense, non-GAAP financial measures, the accounting for income tax effects of share-based payment arrangements, disclosures in Management's Discussion and Analysis subsequent to adoption of SFAS No. 123R and modification of options prior to the adoption of SFAS No. 123R. We are currently assessing the guidance in SAB 107 as part of our evaluation of the adoption of SFAS No. 123R.

On December 16, 2004, the FASB issued SFAS No. 153, *Exchanges of Non-monetary Assets, an amendment of APB Opinion No. 29, Accounting for Non-monetary Transactions*. SFAS No. 153 addresses the measurement of exchanges of non-monetary assets and redefines the scope of transactions that should be measured based on the fair value of the assets exchanged. SFAS No. 153 became effective for non-monetary asset exchanges beginning in our second quarter of fiscal 2006. Adoption of SFAS No. 153 did not have a material effect on our consolidated financial position, results of operations or cash flows.

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

In November 2005, the FASB issued FASB Staff Position (FSP) Nos. FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. FSP Nos. FAS 115-1 and FAS 124-1 amend SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. This guidance nullifies certain requirements of EITF 03-1, *The Meaning of Other-Than-Temporary*

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Impairment and its Application to Certain Investments. FSP Nos. FAS 115-1 and FAS 124-1 include guidance for evaluating and

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recording impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are deemed to be temporarily impaired. FSP Nos. FAS 115-1 and FAS 124-1 also require other-than-temporary impaired debt securities to be written down to its impaired value, which becomes the new cost basis. FSP Nos. FAS 115-1 and FAS 124-1 are effective for fiscal years beginning after December 15, 2005. We do not believe that adoption of FSP Nos. FAS 115-1 and FAS 124-1 on June 1, 2006 will have a material impact on our financial position, results of operations or cash flows.

In July 2006, the FASB issued Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with Statement 109 and prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Additionally, Interpretation 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006, with early adoption permitted. We will adopt FIN 48 in fiscal 2008 and are currently evaluating whether the adoption of FIN 48 will have a material effect on our consolidated financial position, results of operations or cash flows.

3. Acquisitions**Centra Software, Inc.**

On January 31, 2006, Saba acquired Centra Software, Inc. (Centra), a leading provider of software and services for online learning and training. As part of Saba's strategy to establish itself as the market leader in the enterprise learning software industry, Saba acquired Centra to leverage the Company's collaborative learning offering in order to provide the industry's first complete enterprise learning solution.

The Centra acquisition has been accounted for as a business combination. Assets acquired and liabilities assumed were recorded at their fair values as of January 31, 2006. The results of operations for Centra are included in the statement of operations of the Company for the period from February 1, 2006 through May 31, 2006. The total preliminary purchase price is \$62.3 million, including acquisition related transaction costs, and is comprised of (in thousands):

Saba common stock (10.4 million shares valued at \$3.65)	\$ 37,820
Cash	19,419
Acquisition transaction costs	5,084
	<hr/>
Total preliminary purchase price	\$ 62,323
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Acquisition related transaction costs include legal and accounting fees, accrued restructuring costs (see Note 13) and other external costs directly related to the Centra acquisition. The Saba common stock was valued based on the average closing sales price on the Nasdaq Global Market (formerly the Nasdaq National Market) from two days before and two days after the announcement of the transaction, October 6, 2005.

Table of Contents**SABA SOFTWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Under business combination accounting, the total preliminary purchase price was allocated to Centra's net tangible and identifiable intangible assets based on their estimated fair values as of January 31, 2006. The excess of the purchase price over the net tangible and identifiable intangible assets was recorded as goodwill. The total purchase price was allocated as follows (in thousands):

		Estimated Useful Lives
Cash	\$ 27,731	
Accounts receivable	4,333	
Prepaid expenses	900	
Property and equipment	928	
Acquired Developed Technology	5,890	5 years
Customer relationships	10,170	6 years
Tradenames	820	5 years
Customer backlog	440	2 years
In-process research and development	760	
Goodwill	23,279	
Other assets	481	
Accounts payable	(1,653)	
Deferred revenue	(6,790)	
Accrued expenses	(3,701)	
Short and long-term debt	(702)	
Other long-term liabilities	(563)	
	<hr/>	
Total preliminary purchase price	\$ 62,323	
	<hr/>	

The preliminary allocation of the purchase price was based upon an estimated fair value of developed core technology, customer relationships, tradenames, customer backlog and in-process research and development, and was determined by management with the assistance of a third-party valuation. In performing the purchase price allocation of acquired intangible assets, the Company considered its intention for future use of the assets, analyses of historical financial performance and estimates of future performance of Centra's products, among other factors. In addition to identifiable intangible assets, the Company also purchased certain technologies being developed by Centra at the time of the acquisition, which is commonly referred to as In-Process Research and Development (IPR&D). The IPR&D acquired primarily related to Centra's products designed specifically for online business communication, collaboration and learning. Because the IPR&D had not yet reached technological feasibility and had no alternative future use, Saba recorded a \$760,000 expense under the heading in-process research and development in the accompanying consolidated statements of operations upon acquisition.

The Company determined the fair values of identifiable intangible assets and the IPR&D using the income valuation approach with discount rates ranging from 18% to 23%. The discount rates selected were based in part on considerations of the rate of return implied by the purchase price and the risk associated with achieving forecasted cash flows for Centra. Further, the Company also considered risks associated with achieving anticipated levels of market penetration, the successful completion of its research and development efforts and risks related to the impact of potential changes in future target markets.

The primary areas of the purchase price allocation that are not yet finalized relate to certain legal matters. If information becomes available to the Company prior to the end of the purchase price allocation period that would indicate that a liability is probable and the amount can be reasonably estimated, such items will be included in the purchase price allocation.

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SABA SOFTWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Net tangible assets were valued at their respective historical carrying amounts as these approximate fair value, except for deferred revenues and prepaid royalties that were written down to amounts that approximate their current fair values. Deferred revenues were reduced by \$8.1 million to adjust deferred revenue to an amount equivalent to Saba's legal obligation representing the estimated cost plus an appropriate profit margin to perform the services related to Centra's software support and hosting contracts and performance of pre-paid professional services. Certain royalties for third-party technology rights were written-off as the Company determined that it would replace the third-party technology with the Company's previously developed technology.

The results of operations of Centra are included in the Company's consolidated financial statements from February 1, 2006. The pro forma results of operations disclosed below give effect to the acquisition of Centra as if the acquisition was consummated on June 1, 2004.

THINQ Learning Solutions, Inc.

On May 5, 2005, Saba acquired THINQ Learning Solutions, Inc. to support its long-term strategic direction, strengthen its competitive position in the Human Capital Management market, expand its customer base and provide greater scale to increase its investment in research and development to accelerate innovation and increase stockholder value.

The total purchase price was \$8.7 million, which consisted of \$8.0 million of Saba common stock, \$570,000 in cash for transaction costs and \$100,000 in cash paid to THINQ stockholders. In allocating the purchase price based on estimated fair values, Saba recorded approximately \$9.6 million of goodwill, \$5.1 million of identifiable intangible assets and \$5.9 million of net liabilities. The allocation of goodwill decreased by \$279,000 in fiscal 2006 as a result of the return of approximately \$689,000 of common stock held in escrow, partially offset by an increase in pre-merger liabilities resulting from the acquisition. As of May 31, 2006, approximately 281,000 shares remained in escrow.

In addition, up to an additional 100,000 shares of Company common stock may be issued in three equal installments over a three-year period pursuant to an earn-out provision that is based on the number of THINQ customers that migrate to the Saba platform (the THINQ customer earn-out). These shares, if issued, will be accounted for as additions to the purchase price in the periods in which they are earned. As of May 31, 2006, no shares have been issued.

Pro Forma Financial Information

The results of operations of Centra and THINQ are included in the Company's consolidated financial statements from the dates of acquisition. The following table presents the pro forma results of operations and gives effect to the acquisition of Centra and THINQ as if the acquisitions were consummated at the beginning of each period presented. Centra and THINQ's fiscal years ended on December 31 and their historical results have been aligned to more closely conform to Saba's May 31 fiscal year end. The pro forma financial information is presented for information

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purposes only and is not indicative of the results of operations that would have been achieved if the acquisition had taken place at the beginning of the periods presented (in thousands, except per share amount).

	Year ended May 31,	
	2006	2005
Total revenues	\$ 99,090	\$ 85,635
Net loss	\$ (5,392)	\$ (21,906)
Basic and diluted net loss per share	\$ (0.19)	\$ (0.81)

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SABA SOFTWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Property and Equipment

Property and equipment consists of the following (in thousands):

	May 31,		Estimated Useful Lives
	2006	2005	
Computer equipment	\$ 11,693	\$ 9,856	1 to 3 Years
Office furniture and fixtures	1,864	1,911	5 Years
Leasehold improvements	1,035	1,005	1 to 5 Years
Construction in process	155		
	<u>14,747</u>	<u>12,772</u>	
Less accumulated depreciation and amortization	(12,575)	(11,898)	
	<u>\$ 2,172</u>	<u>\$ 874</u>	

5. Purchased Intangible assets and Goodwill

The following tables provide a summary of the carrying amounts of purchased intangible assets that continue to be amortized:

	May 31, 2006			Weighted Average Useful Life
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	
	(in thousands)			
Customer backlog	\$ 740	\$ (181)	\$ 559	2.4 Years
Customer relationships	14,920	(1,293)	13,627	6.3 Years
Tradenames	820	(54)	766	5 Years
Acquired developed technology	5,890	(393)	5,497	5 Years

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Total	\$ 22,370	\$ (1,921)	\$ 20,449
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	May 31, 2005			
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Useful Life
		(in thousands)		
Customer backlog	\$ 300	\$ (8)	\$ 292	3 Years
Customer relationships	4,750	(49)	4,701	7 Years
Total	\$ 5,050	\$ (57)	\$ 4,993	

Amortization expense related to purchased intangible assets was \$1,864,000, \$59,000 and \$540,000 in fiscal 2006, fiscal 2005 and fiscal 2004, respectively. The total expected future amortization related to purchased intangible assets will be approximately \$4,035,000, \$3,955,000, \$3,716,000, \$3,716,000 and \$3,268,000 in fiscal years 2007 through 2011, respectively, and \$1,759,000 thereafter.

SFAS No. 142, *Goodwill and Other Intangible Assets*, prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment; while the second phase, if necessary, measures the impairment. Saba's reporting unit equates to its business segment as discussed in Note 10. Accordingly, all of Saba's goodwill is associated with the entire company. During the fourth quarter of fiscal 2006, Saba performed

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the required annual impairment analysis and determined that there was no indication of impairment of goodwill. Any future reduction of the enterprise fair value below the amount of stockholders' equity could require Saba to write down the value of goodwill to its fair value and record an expense for the impairment loss.

The changes in the carrying amount of goodwill as of May 31, 2006 and 2005 are as follows (in thousands):

	Net Carrying Amount

Goodwill, as of May 31, 2004	\$ 5,288
Add: Goodwill related to the THINQ acquisition	9,876

Goodwill, as of May 31, 2005	15,164
Adjustments to goodwill related to the THINQ acquisition	(279)
Add: Goodwill related to the Centra acquisition	23,279

Goodwill, as of May 31, 2006	\$ 38,164

6. Debt and Lease Obligations***Note Payable***

As part of the acquisition of Human Performance Technologies, Inc. in March 2001, Saba assumed a liability of \$420,000 that represented payments due under an intellectual property agreement. The liability is being repaid in quarterly installments of \$17,500 through December 31, 2006. The remaining balance due was \$52,500 and \$122,500 at May 31, 2006 and 2005, respectively.

Credit Facility

Since August 2002, Saba has maintained a credit facility with a bank. On January 31, 2006, the Company entered into a new credit facility with the bank. The credit facility replaces the Company's existing credit facility with the bank. The credit facility provides for (i) a term loan in a principal amount of \$6,500,000, and (ii) a receivables borrowing base revolving credit line in an aggregate principal amount of up to \$7,500,000

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at any time outstanding, which includes a sub-limit of up to \$5,000,000 for letters of credit, cash management and foreign exchange services. The term loan will be repaid in 36 equal monthly installments of principal, plus interest. The maturity date of the term loan and the revolving credit line is January 31, 2009. The interest rate applicable to the loans under the credit facility is the bank's prime rate plus 0.50% for the term loan and the bank's prime rate plus 0.25% for borrowings under the revolving credit line. The Company is required to pay an early termination fee if the credit facility is terminated by the bank due to the occurrence of an event of default or is refinanced by another financial institution, in each case, prior to the second anniversary of the credit facility. As of May 31, 2006, the Company had borrowings under the term portion of the credit facility of \$6.0 million. As of May 31, 2006, there were no borrowings and \$6.8 million was available under the accounts receivable borrowing base portion of the revolving credit line.

The credit facility is secured by all of the Company's personal property other than its intellectual property. The credit facility includes certain negative covenants restricting or limiting the ability of the Company and its subsidiaries to, among other things: incur additional indebtedness; create liens on its property; make certain investments and acquisitions; merge or consolidate with any other entity; convey, sell, lease, transfer or otherwise dispose of assets; change its business; experience a change of control; pay dividends, distributions or make other specified restricted payments; and enter into certain transactions with affiliates. Such restrictions and limitations are subject to usual and customary exceptions contained in credit agreements of this nature. In

Table of Contents**SABA SOFTWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In addition, the credit facility requires the Company to satisfy a minimum consolidated EBITDA covenant on a quarterly basis and a minimum liquidity covenant on a monthly basis. EBITDA, or earnings before income tax, depreciation and amortization, also excludes stock-based compensation and includes the estimated revenue that would have been recorded related to the Centra deferred revenue fair value adjustment. As of May 31, 2006, the Company was in compliance with all covenants. If we violate any of these restrictive covenants or otherwise breach the credit facility agreement, the Company may be required to repay the obligations under the credit facility prior to their stated maturity date, the Company's ability to borrow under the revolving credit line may be terminated and the bank may be able to foreclose on any collateral provided by the Company.

Leases

Saba leases its office facilities under various non-cancelable operating leases that expire at various dates through 2014. Rent expense was \$4.6 million, \$3.9 million and \$4.2 million in fiscal 2006, 2005 and 2004, respectively. Rent expense under certain of Saba's facility leases is recognized on a straight-line basis over the term of the lease. The difference between the amounts paid and the amounts expensed is classified as accrued rent in the consolidated balance sheets.

The following table summarizes Saba's future minimum lease payments, net of sublease income for operating leases, and principal payments under debt obligations as of May 31, 2006. Of the \$26.8 million in operating leases, \$503,000, which is net of estimated sublease income of \$550,000, is included in accrued restructuring charges as of May 31, 2006.

Contractual obligations:	Payments due by period						
	Total	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	Thereafter
Long-Term debt obligations	\$ 6,292	\$ 2,330	\$ 2,247	\$ 1,694	\$ 21	\$	\$
Operating lease obligations	26,766	4,144	3,916	2,608	2,729	2,613	10,756
Other long-term liabilities	1,100	655	130	105	105	105	
Total	\$ 34,158	\$ 7,129	\$ 6,293	\$ 4,407	\$ 2,855	\$ 2,718	\$ 10,756

7. Stockholders' Equity**Shares of Common Stock Reserved for Future Issuance**

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As of May 31, 2006 Saba had reserved the following shares of common stock for issuance:

Stock options outstanding	3,932,104
Stock options available for future grant	233,701
Employees stock purchase plan	1,005,169
THINQ customer earn-out	100,000
	<hr/>
	5,270,974
	<hr/>

Employee Stock Purchase Plan

Under the Company's 2000 Employee Stock Purchase Plan (ESPP), eligible employees may purchase common stock at 85% of the lesser of the fair market value of Saba's common stock on the first day of the applicable two-year offering period or the last day of the applicable six-month purchase period. Beginning June 1, 2001, shares reserved for issuance under the ESPP increase annually in increments equal to the lesser of (i) 500,000 shares, (ii) two percent of the outstanding shares on June 1, or (iii) a lesser number of shares

Table of Contents**SABA SOFTWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

determined by the Board of Directors. Shares issued under the ESPP were 56,121 during fiscal 2006 and 51,244 during fiscal 2005. As of May 31, 2006, 1,005,169 shares were available for issuance under the ESPP.

Stock Option Plans

Under the 1997 Stock Option Plan, as amended, (the 1997 Plan), Saba may grant options to purchase up to 2,703,807 shares of common stock to employees, directors and consultants at prices not less than the fair market value at the date of grant for incentive stock options and not less than 85% of fair market value for non-statutory stock options (110% in certain circumstances). Options generally expire ten years from the date of grant and generally vest over four years. As of May 31, 2006, 92,523 shares were available for issuance under the 1997 Plan.

In January 2000, the Board of Directors adopted the 2000 Stock Incentive Plan (the 2000 Plan) and reserved 1,500,000 shares for grant under the 2000 Plan. The terms of the 2000 Plan are substantially similar to the 1997 Plan, except that options generally expire six years from the date of grant. Beginning June 1, 2001, stock options reserved for issuance under the 2000 Plan increase annually in increments equal to the lesser of (i) 750,000 shares, (ii) five percent of the outstanding shares on June 1, or (iii) a lesser number of shares determined by the Board of Directors. As of May 31, 2006, 141,178 shares were available for issuance under the 2000 Plan.

Details of activity under the 1997 Plan and 2000 Plan are as follows:

	Number	Weighted-
	of Shares	Average
		Exercise
		Price
		per Share
	<u> </u>	<u> </u>
Balance, May 31, 2003	2,731,770	\$ 13.38
Granted	1,295,900	3.70
Exercised	(19,291)	1.82
Canceled	(1,513,788)	14.68
	<u> </u>	
Balance, May 31, 2004	2,494,591	\$ 7.65
Granted	494,850	4.12
Exercised	(57,086)	2.86
Canceled	(714,091)	8.91
	<u> </u>	
Balance, May 31, 2005	2,218,264	\$ 6.58
Granted	2,527,650	4.63
Exercised	(233,098)	3.53

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Canceled	(580,712)	8.10
Balance, May 31, 2006	<u>3,932,104</u>	\$ 5.28

Table of Contents**SABA SOFTWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Additional information regarding options outstanding as of May 31, 2006 is as follows:

Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted-Average Contractual Life (Years)	Weighted-Average Exercise Price	Number	Weighted-Average Exercise Price
\$0.20 - 2.52	278,035	2.6	\$ 2.19	238,810	\$ 2.13
\$2.53 - 3.62	72,050	3.9	\$ 3.53	34,443	\$ 3.53
\$3.63 - 3.63	348,077	3.1	\$ 3.63	215,627	\$ 3.63
\$3.78 - 3.78	406,000	3.8	\$ 3.78	211,856	\$ 3.78
\$3.80 - 5.00	1,413,944	5.0	\$ 4.25	320,045	\$ 4.20
\$5.01 - 7.40	1,188,758	4.1	\$ 5.32	117,408	\$ 6.71
\$8.12 - 11.00	151,201	1.5	\$ 8.52	148,655	\$ 8.50
\$11.01 - 39.36	39,052	1.1	\$ 24.23	39,052	\$ 24.23
\$40.00 - 117.50	34,987	0.2	\$ 72.50	34,987	\$ 72.50
	3,932,104	4.3	\$ 5.28	1,360,883	\$ 6.68

Saba recorded deferred stock compensation of approximately \$37.1 million during fiscal 2000 and \$1.3 million during fiscal 1999 representing the difference between the exercise price and the deemed fair value for financial accounting purposes of Saba's common stock on the grant date for certain stock options granted to employees. These amounts were being amortized by charges to operations over the vesting periods of the individual stock options using a graded vesting method. Amortization of deferred stock compensation amounted to approximately \$45,000 for fiscal 2004. There was no amortization of deferred stock compensation during fiscal 2006 and 2005 as all amounts were fully amortized as of May 31, 2004. Amortization of deferred stock compensation and other stock charges relates to the following:

	Year ended May 31, 2004
	(in thousands)
Cost of services	\$ 4
Research and development	6
Sales and marketing	5
General and administrative	30
	\$ 45

8. Income Taxes

The provision for income taxes of \$285,000 for fiscal 2006, \$248,000 for fiscal 2005 and \$108,000 for fiscal 2004 has been comprised entirely of income taxes related to foreign operations.

Pretax income from foreign operations was approximately \$501,000 in fiscal 2006, \$425,000 in fiscal 2005 and \$221,000 in fiscal 2004.

Table of Contents**SABA SOFTWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of deferred tax assets are as follows (in thousands):

	May 31,	
	2006	2005
Deferred tax assets:		
Net operating loss carryforwards	\$ 76,807	\$ 55,608
Deferred revenue	62	
Accruals	2,609	1,638
Property, equipment and purchased intangible assets	1,889	2,535
Tax credit carryforwards	2,978	2,493
Other assets		263
	<u>84,345</u>	<u>62,537</u>
Valuation allowance	(76,131)	(60,487)
	<u>8,214</u>	<u>2,050</u>
Total deferred tax assets	8,214	2,050
Deferred tax liabilities:		
Purchased intangible assets	(8,210)	(2,047)
Other	(4)	(3)
	<u>(8,214)</u>	<u>(2,050)</u>
Net deferred tax assets	<u>\$</u>	<u>\$</u>

Realization of deferred tax assets is dependent upon future taxable income, if any, the timing and amount of which are uncertain. Accordingly, a valuation allowance in an amount equal to the net deferred tax has been established to reflect these uncertainties. The valuation allowance increased by \$15.6 million in fiscal 2006 and increased by \$2.4 million in fiscal 2005. Approximately \$40,000 of the valuation allowance at May 31, 2006 is attributable to benefits of stock option deductions, which, if recognized, will be allocated directly to stockholders' equity.

Approximately \$20.9 million of the valuation allowance is attributable to net operating losses and credit carryforwards from business combinations, which if recognized will be credited to goodwill, other non-current intangible assets or stockholders' equity.

A reconciliation of income tax expense at the statutory federal income tax rate to net income tax expense included in the accompanying consolidated statements of operations is as follows:

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	Years ended May 31,		
	2006	2005	2004
	(in thousands)		
U.S. federal benefit at statutory rate	\$ (2,326)	\$ (1,108)	\$ (4,402)
Net operating loss and temporary differences for which no benefit was realized	2,185	1,213	4,405
Unbenefitted net foreign losses	104	101	67
Purchased in-process research and development	266		
Nondeductible expenses	56	42	38
Total	\$ 285	\$ 248	\$ 108

As of May 31, 2006, the Company had net operating loss carryforwards of approximately \$209 million for federal tax purposes and approximately \$106 million for state tax purposes. Saba also has research credit

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SABA SOFTWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

carryforwards of approximately \$1.3 million for federal tax purposes and approximately \$2.5 million for state tax purposes. If not utilized, the federal net operating loss and research credit carryforwards will expire in various amounts from fiscal 2010 through fiscal 2026. The state net operating loss carryforwards will expire in fiscal 2007 through 2026 and the California state research credit will carry forward indefinitely. The Massachusetts research credit carryforward will expire beginning in 2015. Utilization of the net operating loss and tax credit carryforwards may be subject to substantial annual limitations due to the ownership change limitations provided by the Internal Revenue Code and similar state provisions. The annual limitations could result in the expiration of the net operating loss and tax credit carryforwards before utilization.

The tax returns of one of the Company's subsidiaries are currently under examination. The Company has concluded that it is probable that the examination will result in an additional liability. The Company believes that adequate tax provisions have been provided for the likely outcome of the ongoing examination.

9. Retirement Plan

Saba has established the Saba Software 401(k) Plan (the "401(k) Plan") under section 401(k) of the Internal Revenue Code, covering substantially all of its U.S. employees. Under the 401(k) Plan, participating employees may defer a portion of their pretax earnings subject to an annual contribution limit. Saba may also make matching contributions equal to a discretionary percentage of the employees' deferral. To date, no matching contributions have been made.

10. Segment Information

Saba operates in a single operating segment, providing software and services that increase business performance through human capital development and management.

Geographic Information

The following tables represent revenue and long-lived assets information by geographic area as of and for the fiscal years ended May 31. Long-lived assets consist of property and equipment, goodwill and purchased intangible assets:

Total Revenue	Long-Lived Assets
---------------	-------------------

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	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2006</u>	<u>2005</u>
	(in thousands)				
United States	\$ 51,494	\$ 24,481	\$ 19,224	\$ 60,639	\$ 20,791
International	19,653	17,729	15,247	236	240
Total	\$ 71,147	\$ 42,210	\$ 34,471	\$ 60,875	\$ 21,031

Major Customers

For fiscal 2006, 2005 and fiscal 2004, no customer accounted for greater than 10% of revenues.

11. Litigation

In November 2001, a complaint was filed in the United States District Court for the Southern District of New York against the Company, certain of its officers and directors, and certain underwriters of its initial public offering. The complaint was purportedly filed on behalf of a class of certain persons who purchased our common

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SABA SOFTWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

stock between April 6, 2000 and December 6, 2000. The complaint alleges violations by the Company and its officers and directors of Section 11 of the Securities Act of 1933, Section 10(b) of the Exchange Act of 1934, and other related provisions in connection with certain alleged compensation arrangements entered into by the underwriters in connection with the offering. An amended complaint was filed in April 2002. Similar complaints have been filed against hundreds of other issuers that have had initial public offerings since 1998. The complaints allege that the prospectus and the registration statement for the offering failed to disclose that the underwriters allegedly solicited and received excessive commissions from investors and that some investors in the IPO offering agreed with the underwriters to buy additional shares in the aftermarket in order to inflate the price of our stock. The complaints were later consolidated into a single action. The complaint seeks unspecified damages, attorney and expert fees, and other unspecified litigation costs.

On July 1, 2002, the underwriter defendants in the consolidated actions moved to dismiss all of the actions, including the action involving the Company. On July 15, 2002, the Company, along with other non-underwriter defendants in the coordinated cases, also moved to dismiss the litigation. On February 19, 2003, the Court ruled on the motions. The Court granted the Company's motion to dismiss the claims against it under Rule 10b-5, due to the insufficiency of the allegations against us. The Court also granted the motion of the individual defendants, Bobby Yazdani and Terry Carlitz, the Company's Chief Executive Officer and Chairman of the Board and former Chief Financial Officer and a member of the Company's board of directors, to dismiss the claims against them under Rule 10b-5 and Section 20 of the Exchange Act. The motions to dismiss the claims under Section 11 of the Securities Act were denied as to virtually all of the defendants in the consolidated cases, including the Company.

On July 16, 2003, a committee of the Company's board of directors conditionally approved a proposed partial settlement with the plaintiffs in this matter. The settlement would provide, among other things, a release of the Company and of the individual defendants for the conduct alleged in the action to be wrongful in the amended complaint. The Company would agree to undertake other responsibilities under the partial settlement, including agreeing to assign away, not assert, or release certain potential claims the Company may have against its underwriters. Any direct financial impact of the proposed settlement is expected to be borne by the Company's insurers.

In June 2004, an agreement of settlement was submitted to the Court for preliminary approval. The Court granted the preliminary approval motion on February 15, 2005, subject to certain modifications. On August 31, 2005 the Court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. The Court also appointed the notice administrator for the settlement and ordered that notice of the settlement be distributed to all settlement class members by January 15, 2006. The settlement fairness hearing has been set for April 24, 2006. If the Court determines that the settlement is fair to the class members, the settlement will be approved. There can be no assurance that this proposed settlement will be approved and implemented in its current form, or at all.

If the settlement process fails, the Company intends to dispute these claims and defend the law suit vigorously. However, due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the litigation. An unfavorable outcome in litigation could materially and adversely affect the Company's business, financial condition and results of operations.

Centra, certain of its former officers and directors and the managing underwriters of Centra's initial public offering were named as defendants in an action filed in the United States District Court for the Southern District of New York. The plaintiffs filed an initial complaint on December 6, 2001 and purported to serve the Centra defendants on or about March 18, 2002. The original complaint has been superseded by an amended

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complaint (complaint) filed in April 2002. The action, captioned in re Centra Software, Inc. Initial Public Offering Securities Litigation, No. 01 CV 10988, which is being coordinated with an action captioned in re Initial Public

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SABA SOFTWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Offering Securities Litigation, No. 21 MC 92, is purportedly brought on behalf of the class of persons who purchased Centra's common stock between February 3, 2000 and December 6, 2000. The complaint asserts claims under Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The complaint alleges that, in connection with Centra's initial public offering in February 2000, the underwriters received undisclosed commissions from certain investors in exchange for allocating shares to them and also agreed to allocate shares to certain customers in exchange for the agreement of those customers to purchase additional shares in the after-market at pre-determined prices. The complaint asserts that Centra's registration statement and prospectus for the offering were materially false and misleading due to their failure to disclose these alleged arrangements. The complaint seeks damages in an unspecified amount against Centra and the named individuals. The underwriter defendants and the Centra defendants joined in motions to dismiss the above-referenced action on July 3 and July 15, 2002, respectively. On October 9, 2002, the plaintiffs dismissed, without prejudice, the claims against the named Centra officers and directors in the above-referenced action. On February 19, 2003, the court issued an order denying the motion to dismiss as to Centra and other defendants. On June 7, 2003, the plaintiffs announced a proposed settlement with all issuers, including Centra. On June 25, 2004, the plaintiffs filed a motion with the United States District Court for the Southern District of New York requesting preliminary approval of the settlement. The court has given preliminary approval of the settlement. Centra plans to participate in this settlement, which has been negotiated, and will be fully funded directly to the plaintiffs, by Centra's insurers. No amount has been accrued related to this matter and legal costs incurred in the defense of the matter are being expensed as incurred.

On August 19, 2003, a complaint was filed against Centra and two other defendants by EdiSync Systems, LLC, in the United States District Court for the District of Colorado (No. 03-D-1587 (OES)). The complaint alleges infringement of two patents for a remote multiple user editing system and method and seeks permanent injunctive relief against continuing infringement, compensatory damages in an unspecified amount, and interest, costs and expenses associated with the litigation. Centra has filed an answer to the complaint denying all of the allegations. No amount has been accrued related to this matter and legal costs incurred in the defense of the matter are being expensed as incurred. Centra filed a request for reexamination of the patents at issue with the U.S. Patent and Trademark Office. Our patent counsel is of the opinion that claims of the patents involved in the suit are invalid. The re-examination request was accepted by the Patent Office and the District Court has approved the parties' motion to stay the court proceedings during the re-examination proceedings. The Patent Office has issued a non-final rejection of all claims in each of the patents. EdiSync elected not to respond to the rejection of the claims in one of the two patents, effectively rendering that patent of no further force or effect. Saba believes that it has meritorious defenses with respect to the other patent and Saba intends to vigorously defend this action.

The Company is also party to various legal disputes and proceedings arising from the ordinary course of general business activities. While, in the opinion of management, resolution of these matters is not expected to have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows, the ultimate outcome of any litigation is uncertain. Were an unfavorable outcome to occur, the impact could be material to the Company.

12. Guarantees

Saba enters into license agreements that generally provide indemnification against intellectual property claims for its customers. To date, Saba has not incurred any material costs as a result of such indemnifications and has not accrued any liabilities related to such obligations in its consolidated financial statements.

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Saba's license agreements also generally include a warranty that its software products will substantially operate as described in the applicable program documentation generally for a period of 90 days after delivery. To date, Saba has not incurred or accrued any material costs associated with these warranties.

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SABA SOFTWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. Restructuring

As part of the acquisition of Centra, management approved and initiated a plan to restructure and eliminate duplicative pre-merger activities and reduce the Company's cost structure (the Centra Restructuring). Total restructuring costs associated with exiting activities of Centra at January 31, 2006 were preliminarily estimated to be approximately \$2.0 million. During fiscal 2006, additional costs related to facilities were identified and accrued as of May 31, 2006. These costs were included as part of the Centra preliminary purchase price allocation. The components of accrued restructuring charges and movements within these components through May 31, 2006 for the Centra Restructuring were as follows:

	Workforce Reduction Charges	Facilities Related Charges	Total
	(in thousands)		
Accrual as of January 31, 2006	\$ 1,415	\$ 559	\$ 1,974
Additions		159	159
Deductions - cash payments	(491)	(137)	(628)
Impact of exchange rates	3	12	15
Accrual as of May 31, 2006	<u>\$ 927</u>	<u>\$ 593</u>	<u>\$ 1,520</u>

During fiscal 2006, Saba implemented a restructuring program (the 2006 Restructuring) to consolidate excess facilities as a result of its acquisitions of THINQ and Centra. The restructuring program was implemented under the provisions of SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*.

During 2006, the facilities restructuring charges of \$358,000 were based on the present value of the sum of non-cancelable lease costs, less estimates for future sublease income, which will be paid over the estimated vacancy periods through fiscal 2008. During fiscal 2005, we reduced our facilities restructuring reserve for \$32,000 as a result of an amendment to a sub-tenant agreement. During fiscal 2004, the net restructuring charges of \$432,000 were comprised of \$473,000 for excess facilities and a reduction to a prior year workforce reduction accrual of \$41,000 that resulted from severance payments that were less than previous estimates.

During fiscal 2004 and prior years, Saba implemented restructuring programs (the 2004 Restructuring) to reduce expenses to align its operations and cost structure with market conditions. The restructuring programs during fiscal 2004 were implemented under the provisions of SFAS No. 146 while the restructuring programs during the prior years were implemented under EITF No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. The restructuring programs included the consolidation of excess facilities and worldwide workforce reductions across all functions. Workforce reduction charges consisted primarily of severance and fringe benefits. The restructuring charges are classified in the statement of operations as follows:

	<u>Years ended May 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
	(in thousands)		
Cost of revenues	\$	\$	\$ 154
Research and development			166
Sales and marketing			73
General and administrative	358	(32)	39
Total	\$ 358	\$ (32)	\$ 432

Table of Contents**SABA SOFTWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The charges for excess facilities relates to non-cancelable lease costs partially offset by estimated sublease income. Amounts related to the lease termination charges will be paid over the respective lease terms through fiscal 2008. Saba's estimated costs to exit these facilities are based on available commercial rates. The actual loss incurred in exiting these facilities could be different from Saba's estimates.

The components of accrued restructuring charges and movements within these components through May 31, 2006 for the 2006 Restructuring and the 2004 Restructuring were as follows:

	Workforce Reduction Charges	Facilities Related Charges	Total
	_____	_____	_____
	(in thousands)		
Accrual as of May 31, 2003	\$ 129	\$ 880	\$ 1,009
Charges		473	473
Reduction of accrual	(41)		(41)
Deductions cash payments	(21)	(697)	(718)
Accretion and other charges (net)	5	21	26
	_____	_____	_____
Accrual as of May 31, 2004	72	677	749
Reduction of Accrual		(32)	(32)
Deductions cash payments	(50)	(394)	(444)
	_____	_____	_____
Accrual as of May 31, 2005	22	251	273
Charges		440	440
Deductions cash payments	(22)	(233)	(255)
	_____	_____	_____
Accrual as of May 31, 2006	\$	\$ 458	\$ 458
	_____	_____	_____

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**ITEM 9: CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING
AND FINANCIAL DISCLOSURE**

None.

ITEM 9A: CONTROLS AND PROCEDURES

The Company, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective as of May 31, 2006 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

There were no changes in the Company's internal control over financial reporting during the Company's fiscal fourth quarter ended May 31, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

ITEM 9B: OTHER INFORMATION

None.

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PART III

ITEM 10: DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this item is incorporated by reference to the sections entitled Election of Directors, Management and Section 16(a) Beneficial Ownership Reporting Compliance in the Company's definitive Proxy Statement for the Annual Meeting of Stockholders to be held on November 2, 2006.

We have adopted a code of ethics that is designed to qualify as a code of ethics within the meaning of Section 406 of the Sarbanes-Oxley Act of 2002 and the rules promulgated thereunder. This code of ethics is available on our website at www.saba.com. To the extent required by law, any amendments to, or waivers from, any provision of the code of ethics will be promptly disclosed to the public. To the extent permitted by such legal requirements, we intend to make such public disclosure by posting the relative material on our website in accordance with SEC rules.

ITEM 11: EXECUTIVE COMPENSATION

The information required by this item is incorporated by reference to the sections entitled Executive Compensation and Related Information and Election of Directors in the Company's definitive Proxy Statement for the Annual Meeting of Stockholders to be held on November 2, 2006.

ITEM 12: SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item is incorporated by reference to the sections entitled Security Ownership of Certain Beneficial Owners and Management and Equity Compensation Plan Information in the Company's definitive Proxy Statement for the Annual Meeting of Stockholders to be held on November 2, 2006.

ITEM 13: CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this item is incorporated by reference to the section entitled Certain Relationships and Related Transactions in the Company's definitive Proxy Statement for the Annual Meeting of Stockholders to be held on November 2, 2006.

ITEM 14: PRINCIPAL ACCOUNTANT FEES AND SERVICES

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The information required by this item is incorporated by reference to the section entitled "Principal Accountant Fees and Services" in the Company's definitive Proxy Statement for the Annual Meeting of Stockholders to be held on November 2, 2006.

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PART IV

ITEM 15: EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this Annual Report on Form 10-K:

1. *Financial Statements*

	Page
<u>Report of Independent Registered Public Accounting Firm</u>	43
<u>Consolidated Balance Sheets</u>	44
<u>Consolidated Statements of Operations</u>	45
<u>Consolidated Statements of Stockholders' Equity</u>	46
<u>Consolidated Statements of Cash Flows</u>	48
<u>Notes to Consolidated Financial Statements</u>	49

2. *Financial Statement Schedules*

All schedules have been omitted as they are either not required or not applicable, or the required information is included in the consolidated financial statements or notes thereto.

3. *Index to Exhibits*

See Index to Exhibits on page 74.

Table of Contents**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

SABA SOFTWARE, INC.

By: /s/ BOBBY YAZDANI

Bobby Yazdani

Chief Executive Officer and

Chairman of the Board

Dated: August 18, 2006

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints each of Bobby Yazdani and Peter Williams as his true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments (including post-effective amendments) to this Report on Form 10-K, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or any of them, or their or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u> /s/ BOBBY YAZDANI </u> Bobby Yazdani	Chief Executive Office and Chairman of the Board (Principal Executive Officer)	August 18, 2006
<u> /s/ PETER E. WILLIAMS III </u> Peter E. Williams III	Chief Financial Officer (Principal Financial and Accounting Officer)	August 18, 2006

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<hr/> <i>/s/</i> DOUGLAS FERGUSON	Director	August 18, 2006
<hr/> Douglas Ferguson		
<hr/> <i>/s/</i> JOE KIANI	Director	August 18, 2006
<hr/> Joe Kiani		
<hr/> <i>/s/</i> LAWRENCE D. LENIHAN, JR.	Director	August 18, 2006
<hr/> Lawrence D. Lenihan, Jr.		
<hr/> <i>/s/</i> LEON NAVICKAS	Director	August 18, 2006
<hr/> Leon Navickas		
<hr/> <i>/s/</i> CLIFTON T. WEATHERFORD	Director	August 18, 2006
<hr/> Clifton T. Weatherford		

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Exhibit	
Number	Document
2.1 ⁽¹⁾	Agreement and Plan of Merger by and among the Company, Storm Holding Corporation, a Delaware corporation that is a wholly-owned subsidiary of the Company (Holding), Storm Acquisition Corporation, a Delaware corporation that is a wholly-owned subsidiary of Holding (the Subsidiary), THINQ Learning Solutions, Inc, a Delaware corporation and an unaffiliated entity (THINQ), and Daniel H. Bathon, Jr. as representative of the stockholders of THINQ.
2.2 ⁽⁸⁾	Agreement and Plan of Reorganization, dated October 5, 2005, by and among the Company, Spruce Acquisition Corporation, a Delaware corporation (Merger Sub 1), Spruce Acquisition, LLC, a Delaware limited liability company (Merger Sub 2) and Centra Software, Inc., a Delaware corporation (Centra).
3.1 ⁽²⁾	Amended and Restated Certificate of Incorporation of the Company effective as of April 12, 2000.
3.2 ⁽³⁾	Amendment to Amended and Restated Certificate of Incorporation of the Company effective as of May 12, 2003.
3.3 ⁽⁴⁾	Amendment to Amended and Restated Certificate of Incorporation of the Company effective as of November 19, 2004.
3.4 ⁽⁵⁾	Amended and Restated Bylaws of the Company effective as of August 10, 2004.
4.1	Reference is made to Exhibits 3.1, 3.2, 3.3 and 3.4.
10.1 ⁽⁶⁾	Form of Indemnification Agreement between the Company and each of its officers and directors.
*10.2 ⁽⁶⁾	1997 Stock Incentive Plan.
*10.3 ⁽⁶⁾	Form of 2000 Stock Incentive Plan.
*10.4 ⁽⁶⁾	Form of 2000 Employee Stock Purchase Plan.
*10.5 ⁽⁷⁾	Form of Notice of Option Grant for Certain Executive Officers
10.6 ⁽⁶⁾	Lease Agreement dated March 16, 1999 between the Company and Westport Joint Venture for the Company's Redwood Shores, California headquarters.
10.7 ⁽⁷⁾	Credit Agreement dated January 31, 2006 between Silicon Valley Bank and the Company.
10.10 ⁽⁹⁾	Purchase Agreement dated as of August 9, 2004, by and between the Company and the selling security holders named therein.
10.11 ⁽⁹⁾	Registration Rights Agreement dated as of August 9, 2004, by and between the Company and the selling security holders pursuant to this registration statement.
10.12 ⁽⁹⁾	Form of Warrant.
*10.13 ⁽¹⁰⁾	Summary of Director Compensation.
*10.14 ⁽⁷⁾	Employment agreement, effective February 1, 2006, by and between the Company and Bobby Yazdani.
*10.15 ⁽⁷⁾	Employment agreement, effective February 1, 2006, by and between the Company and Peter E. Williams III.
*10.16 ⁽¹¹⁾	Letter Agreement, dated September 1, 2005, by and between the Company and Mark D. Frost.
21.1	List of Subsidiaries of the Company.
23.1	Consent of Independent Registered Public Accounting Firm.
24.1	Power of Attorney. (See page 73.)
31.1	Certification of Bobby Yazdani, Chief Executive Officer and Chairman of the Board, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

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Exhibit

Number	Document
31.2	Certification of Peter E. Williams III, Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Bobby Yazdani, Chief Executive Officer and Chairman of the Board, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Peter E. Williams III, Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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- (1) Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the period ended April 14, 2005.
 - (2) Incorporated by reference to Exhibit 3.2 previously filed with the Company's Registration Statement on Form S-1 (Registration No. 333-95761).
 - (3) Incorporated by reference to Exhibit 3.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended November 30, 2003.
 - (4) Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the period ended November 30, 2004.
 - (5) Incorporated by reference is the Company's Annual Report on Form 10-K for the year ended May 31, 2004.
 - (6) Incorporated by reference to the same number exhibit previously filed with the Company's Registration Statement on Form S-1 (Registration No. 333-95761).
 - (7) Incorporated by reference to the Company's Quarterly Report on Form 10-Q filed April 14, 2006.
 - (8) Incorporated by reference to the Company's Current Report on Form 8-K filed October 6, 2005.
 - (9) Incorporated by reference to the Company's Current Report on Form 8-K filed August 11, 2004.
 - (10) Incorporated by reference to the Company's Current Report on Form 8-K filed April 3, 2006.
 - (11) Incorporated by reference to the Company's Quarterly Report on Form 10-Q filed October 17, 2005.

* Management contracts or compensatory plans or arrangements.