SABA SOFTWARE INC
Form 10-Q
October 07, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended August 31, 2010

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

For the transition period from to .

001-34372

(Commission File number)

SABA SOFTWARE, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**94-3267638**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
2400 Bridge Parkway Redwood Shores, California	**94065-1166**
(Address of principal executive offices)	**(Zip Code)**

(650) 581-2500

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	x
Non-Accelerated filer	¨ (do not check if a smaller reporting company)	Smaller reporting company	¨

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

On September 30, 2010, 28,173,685 shares of the registrant s Common Stock, $0.001 par value, were outstanding.

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SABA SOFTWARE, INC.

FORM 10-Q

QUARTER ENDED AUGUST 31, 2010

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

SABA SOFTWARE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

(Unaudited)

	August 31, 2010	May 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 33,192	$ 32,002
Restricted cash	21	20
Accounts receivable, net of allowances for doubtful accounts of $150 as of August 31, 2010 and May 31, 2010	16,722	23,352
Prepaid expenses and other current assets	3,096	1,788
Total current assets	53,031	57,162
Property and equipment, net	2,934	3,178
Goodwill	36,095	36,095
Purchased intangible assets, net	4,099	5,027
Restricted cash	260	260
Other assets	1,982	1,722
Total assets	$ 98,401	$ 103,444
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,343	$ 3,218
Accrued compensation and related expenses	6,567	8,069
Accrued expenses	2,996	2,746
Deferred revenue	31,647	34,435
Current portion of lease obligations	474	450
Total current liabilities	45,027	48,918
Deferred revenue	2,782	2,559
Other long-term liabilities	1,179	1,156
Accrued rent	1,658	1,785
Total liabilities	50,646	54,418
Stockholders equity:		
Preferred stock, issuable in series $0.001 par value, 5,000,000 authorized shares at August 31, 2010 and May 31, 2010; none issued or outstanding		
Common stock, $0.001 par value, 50,000,000 authorized; 28,254,937 shares issued at August 31, 2010 and 28,252,131 shares issued at May 31, 2010	29	29
Additional paid-in capital	257,144	255,938

Treasury stock: 195,497 shares at August 31, 2010 and 121,997 shares at May 31, 2010	(1,075)	(328)
Accumulated deficit	(208,141)	(206,336)
Accumulated other comprehensive loss	(202)	(277)
Total stockholders equity	47,755	49,026
Total liabilities and stockholders equity	$ 98,401	$ 103,444

See Accompanying Notes to Condensed Consolidated Financial Statements.

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SABA SOFTWARE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except share and per share data)

(Unaudited)

	Three months ended August 31, 2010	2009
Revenues:		
Subscription	$ 14,895	$ 13,977
License	4,450	5,712
Professional services	7,469	6,122
Total revenues	26,814	25,811
Cost of revenues:		
Cost of subscription	3,920	4,045
Cost of license	247	210
Cost of professional services	5,426	4,552
Amortization of acquired developed technology	295	295
Total cost of revenues	9,888	9,102
Gross profit	16,926	16,709
Operating expenses:		
Research and development	4,423	4,222
Sales and marketing	9,869	6,788
General and administrative	3,412	3,843
Restructuring		(37)
Amortization of purchased intangible assets	634	634
Total operating expenses	18,338	15,450
Income (loss) from operations	(1,412)	1,259
Interest and other income (expense), net	(225)	(22)
Interest expense	(2)	(3)
Income (loss) before provision for income taxes	(1,639)	1,234
Provision for income taxes	(165)	(214)
Net income (loss)	$ (1,804)	$ 1,020
Basic net income (loss) per share	$ (0.06)	$ 0.03
Diluted net income (loss) per share	$ (0.06)	$ 0.03
Shares used in computing basic net income (loss) per share	28,151	29,220

Shares used in computing diluted net income (loss) per share	28,151	29,833

See Accompanying Notes to Condensed Consolidated Financial Statements.

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SABA SOFTWARE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Three months ended August 31, 2010	2009
Operating activities:		
Net income (loss)	$ (1,804)	$ 1,020
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	558	622
Amortization of purchased intangible assets	929	929
Share-based compensation	814	264
Changes in operating assets and liabilities:		
Accounts receivable	6,886	1,406
Prepaid expenses and other current assets	(1,284)	(258)
Other assets	(243)	51
Accounts payable	109	1,102
Accrued compensation and related expenses	(1,442)	177
Accrued expenses	217	175
Deferred revenue	(2,962)	(4,511)
Accrued rent	(279)	(264)
Net cash provided by operating activities	1,499	713
Investing activities:		
Purchases of property and equipment	(288)	(183)
Net cash used in investing activities	(288)	(183)
Financing activities:		
Proceeds from issuance of common stock under stock plans	392	45
Repurchase of common stock	(747)	(4,847)
Repayments of borrowings under credit facility		(99)
Repayments of note payable		(22)
Net cash used in financing activities	(355)	(4,923)
Effect of exchange rate changes on cash and cash equivalents	334	3
Increase (decrease) in cash and equivalents	1,190	(4,390)
Cash and cash equivalents, beginning of period	32,002	25,978
Cash and cash equivalents, end of period	$ 33,192	$ 21,588
Supplemental disclosure of other cash flow information:		
Cash paid for income taxes, net of refunds	$ 819	$ 230
Cash paid for interest	$	$ 3

See Accompanying Notes to Condensed Consolidated Financial Statements.

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SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The condensed consolidated financial statements include the accounts of Saba Software, Inc. and its wholly owned subsidiaries (Saba or the Company). All intercompany balances and transactions have been eliminated.

The accompanying condensed consolidated balance sheet as of August 31, 2010, the condensed consolidated statements of operations for the three months ended August 31, 2010 and 2009 and the condensed consolidated statements of cash flows for the three months ended August 31, 2010 and 2009 are unaudited. These unaudited interim condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (US GAAP). In the opinion of management, the unaudited interim condensed consolidated financial statements include all adjustments of a normal recurring nature necessary for the fair presentation of the Company s financial position as of August 31, 2010, and the Company s results of operations for the three months ended August 31, 2010 and 2009 and cash flows for the three months ended August 31, 2010 and 2009.

These unaudited condensed consolidated financial statements should be read in conjunction with Saba s audited consolidated financial statements included in Saba s Annual Report on Form 10-K for the fiscal year ended May 31, 2010 filed with the Securities and Exchange Commission (the SEC) on August 12, 2010. The results of operations for the three months ended August 31, 2010 are not necessarily indicative of results for the entire fiscal year ending May 31, 2011 or for any future period.

The condensed consolidated balance sheet at May 31, 2010 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by US GAAP for complete financial statements.

Certain prior year balances have been reclassified to conform to the current year s presentation. Such reclassifications did not affect total revenues, operating income (loss) or net income (loss).

2. Summary of Significant Accounting Policies

Revenue Recognition

Saba recognizes license revenues in accordance with the provisions of ASC 985-605, *Software-Revenue Recognition.* Under ASC 985-605, Saba recognizes license 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.

Saba recognizes revenue earned on software arrangements involving multiple elements using the residual method. Under the residual method revenue is allocated to undelivered element based on vendor-specific objective evidence of fair value of such undelivered elements and the residual amounts of revenue are allocated to delivered 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 subscription offerings and professional services. Accordingly, assuming all other revenue recognition criteria are met, revenues from perpetual licenses are

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SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

recognized upon delivery using the residual method. 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.

Subscription revenues include revenue from Saba products delivered as software as a service in an internet-based cloud architecture and revenue from license updates and product support. Revenue from providing customers with access to Saba products in the cloud is recognized as a service arrangement ratably over the term of the arrangement upon delivery or on an as-used basis if defined in the contract. Certain of the cloud-based offerings are integrated offerings pursuant to which the customers ability to access the Company s software is not separable from the services necessary to operate the software and customers are not allowed to take possession of the Company s software, in which case revenue is recognized under ASC 605-10. Saba s cloud-based offerings also include arrangements with customers that have separately licensed and taken possession of the Company s software. When these offerings are part of a multiple element arrangement involving licenses, Saba recognizes revenue in accordance with ASC 985-605. License updates and product support revenue is also recognized ratably over the term of the arrangement, typically 12 months.

License revenues from licenses with a term of three years or more are generally recognized on delivery if the other conditions of ASC 985-605 are satisfied. License revenues from licenses with a term of less than three years are generally recognized ratably over the term of the arrangement. In arrangements where term licenses are bundled with license updates and product support and such revenue is recognized ratably over the term of the arrangement, Saba allocates the revenue to license revenue and to license updates and product support revenue based on the VSOE of fair value for license updates and product support revenue on perpetual licenses of similar products. 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 ASC 985-605 are satisfied.

Professional services revenues are generally recognized as the services are performed. Although Saba generally provides professional services on a time-and-materials basis, certain services agreements are provided on a fixed-fee basis. For services performed on a fixed-fee basis, revenues are generally recognized on the proportional performance of the project, with performance measured based on hours of work performed. 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 using the percentage-of-completion method or, if Saba is unable to reliably estimate the costs to complete the services, Saba uses the completed-contract method of accounting in accordance with ASC 985-605 and relevant guidance of ASC 605-35 *Construction-Type and Certain Production Type*. A contract is considered complete when all significant costs have been incurred or the item has been accepted by the customer.

If the requirements of ASC 985-605 are not met when Saba bills a customer or a customer pays Saba, the billed or paid amount is recorded as deferred revenue, which is a liability account. As the revenue recognition criteria of ASC 985-605 are satisfied, the requisite amounts are recognized as revenue.

In arrangements that include professional services and delivery of our products in the cloud, but not a license of the Company s software, the Company recognizes revenue for professional services as the services are performed if these professional services qualify as a separate element of the arrangement. If the professional services do not qualify as a separate element of the arrangement, the professional services revenue is recognized ratably over the longest period of the subscription period. Additionally, the Company defers the direct costs related to the professional services and recognizes them ratably over the applicable subscription period. The Company classifies deferred revenue and deferred costs on its consolidated balance sheet as current if the Company expects to recognize such revenue or cost within the following twelve months. When the revenue from professional services is recognized ratably over the subscription, the Company allocates the revenue to professional services revenue and to subscription revenue based on the VSOE of fair value for similar professional services that qualify as a separate element of the arrangement. The Company s judgment as to whether the consulting services qualify as a separate unit of accounting may materially affect the timing of the Company s revenue recognition and results of operations.

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SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Fair Value Measurements

The Company performs fair value measurements in accordance with the guidance provided by the FASB s Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures*. ASC 820 defines fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required to be recorded at their fair values, the Company considers the principal or most advantageous market in which it transacts and considers assumptions that market participants would use when pricing the assets or liabilities, such as inherent risk, transfer restrictions, and risk of nonperformance.

ASC 820 establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. An asset s or liability s categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. ASC 820 establishes three levels of inputs that may be used to measure fair value:

Level 1: quoted prices in active markets for identical assets or liabilities;

Level 2: inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices in active markets for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; or

Level 3: unobservable inputs that are supported by little or no market activity and that are significant to the fair values of the assets or liabilities.

Liabilities Measured at Fair Value on a Recurring Basis

The liabilities measured at fair value on a recurring basis, excluding accrued interest components, consisted of the following types of instruments (Level 2 inputs are defined above):

	Fair Value Measurements Using Input Types Level 2 (in thousands)
Liabilities:	
Derivative financial instruments	$ 96
Current liabilities	$ 96

3. Share-Based Compensation

The Company accounts for share-based payments to employees, including grants of employee stock options, restricted stock units (RSUs) and purchases under employee stock purchase plans, in accordance with ASC 718-10 *Compensation Stock Compensation,* which requires that these awards (to the extent they are compensatory) be recognized in the Company s consolidated statements of operations based on their fair values.

The Company currently uses the Black-Scholes-Merton option pricing model to determine the fair value of stock options and employee stock purchase plan shares. The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as assumptions regarding a number of complex and subjective variables. These variables include the expected term of

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SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

the awards, the Company s expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, the risk-free interest rate and any expected dividends. The Company estimates the expected term of the share-based awards using its historical option activities, including option exercises, restricted stock units and holding patterns. The Company estimates the volatility using its historical stock price volatility over the length of the expected term of the options. The Company bases the risk-free interest rate that it uses in the option valuation model on U.S. Treasury zero-coupon issues with remaining maturities similar to the expected term of the options. The Company does not anticipate paying any cash dividends in the foreseeable future and therefore uses an expected dividend yield of zero in the option valuation model. The Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and record share-based compensation expense only for those awards that are expected to vest. The expected term of employee stock purchase plan shares is the average of the remaining purchase periods under each offering period.

The following assumptions have been used to value the options and awards granted during the three months ended August 31, 2010 and 2009, respectively, under the Company s stock incentive plans and stock purchased under the Company s employee stock purchase plan:

	Three months ended August 31,	
	2010	2009
Stock Options:		
Expected volatility	57%	59%
Risk-free interest rates	2.08%	0.80%
Expected term (years)	5.7	4.1
Expected dividend yield	0%	0%
Employee Stock Purchase Plan:		
Expected volatility	51%	78%
Risk-free interest rates	0.40%	0.53%
Expected term (years)	0.5 2.0	0.5 2.0
Expected dividend yield	0%	0%

The following table summarizes the stock-based compensation expense for stock options, restricted stock units and the Company s employee stock purchase plan shares that was recorded in the Company s condensed consolidated statements of operations for the three months ended August 31, 2010 and 2009, respectively:

	Three months ended August 31,	
	2010	2009
	(in thousands)	
Cost of revenues	$ 107	$ 46
Research and development	123	56
Sales and marketing	279	71
General and administrative	305	91
Share-based compensation expense included in net income (loss)	$ 814	$ 264

The share-based compensation expense categorized by various equity components is summarized in the table below:

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SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

	Three months ended August 31,	
	2010	2009
	(in thousands)	
Stock options	$ 658	$ 223
Restricted stock units	147	19
Employee stock purchase plan	9	22
Total share-based compensation	$ 814	$ 264

RSUs granted by the Board of Directors have been awarded under the Company s 2000 Stock Incentive Plan (the 2000 Stock Plan) and the 2009 Stock Incentive Plan (the 2009 Stock Plan). The RSUs vest in four annual installments commencing on the one year anniversary of the date of the award. During the quarter ended August 31, 2010, 40,000 shares of the RSUs were vested. In order to satisfy tax withholding obligations that arose on the vesting of restricted stock units, 14,547 shares of common stock pursuant to our restricted stock units were repurchased for an aggregate price of approximately $0.1 million.

Share-based compensation expense included $0.1 million during the quarter ended August 31, 2010 resulting from the acceleration of vesting for the Company s former Chief Marketing Officer, upon termination as per his employment agreement.

The weighted average estimated fair value of options granted was $2.60 and $1.89 per share for the three months ended August 31, 2010 and 2009, respectively. The weighted average estimated fair value of RSUs granted was $4.90 and $1.30 per share for the three months ended August 31, 2010 and 2009.

4. Basic and Diluted Net Income (Loss) Per Share

Basic and diluted net income (loss) per share information for all periods is presented under the requirements of ASC 260-10 *Earnings per Share*. Basic earnings per share have been computed using the weighted-average number of shares of common stock outstanding during the period. Basic earnings per share excludes the dilutive effects of options. Dilutive potential common shares consist of shares issuable upon the exercise of stock options and restricted stock unit awards under the treasury stock method. Potentially dilutive issuances have been excluded from the computation of diluted net loss per share as their inclusion would be anti-dilutive, which consist of common stock options, restricted stock unit awards and common stock subject to repurchase. The calculations of basic and diluted net income (loss) per share are as follows:

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SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

(in thousands, except per share data)	Three months ended August 31, 2010	2009
Net income (loss)	$ (1,804)	$ 1,020
Weighted-average shares of common stock used in computing basic net income (loss) per share	28,151	29,220
Effect of dilutive employee stock plans		613
Weighted-average shares of common stock used in computing diluted net income (loss) per share	28,151	29,833
Basic net income (loss) per share	$ (0.06)	$ 0.03
Diluted net income (loss) per share	$ (0.06)	$ 0.03
Shares subject to anti-dilutive stock options and restricted stock-based awards excluded from calculation[1]	4,581	3,505

(1) These weighted shares relate to anti-dilutive stock options and restricted stock-based awards as calculated using the treasury stock method (described above) and could be dilutive in the future.

If Saba had generated net income for the three months ended August 31, 2010, 1.2 million common equivalent shares would have been added to the basic weighted-average shares outstanding for purposes of calculating the diluted weighted-average shares outstanding for the period. For the three months ended August 31, 2009, 0.6 million common equivalent shares related to employee stock plans were added to the basic weighted-average shares outstanding for purposes of calculating the diluted weighted-average shares outstanding.

Shares used in diluted net income per common share calculations exclude anti-dilutive common equivalent shares, consisting of all stock options and restricted stock units, if they have exercise prices that are higher than the average market price of the Company s common stock during the respective periods, under the treasury method. These anti-dilutive common equivalent shares totaled 4.6 million and 3.5 million shares for the three months ended August 31, 2010 and 2009, respectively. While these common equivalent shares are currently anti-dilutive, they could be dilutive in the future.

5. Comprehensive Income (Loss)

The Company reports comprehensive income (loss) in accordance with ASC 220-10 *Comprehensive Income.* The following table sets forth the calculation of comprehensive income (loss) for all the periods presented:

(in thousands)	Three months ended August 31, 2010	2009
Net income (loss)	$ (1,804)	$ 1,020
Foreign currency translation gain (loss)	74	(20)
Comprehensive income (loss)	$ (1,730)	$ 1,000

6. Goodwill and Purchased Intangible Assets

Purchased intangible assets consist of acquired developed technology, customer relationships and trade names acquired as part of a purchase business combination. The intangible assets are stated at cost less accumulated

SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

amortization and are being amortized on a straight-line basis over their estimated useful lives ranging from five to seven years.

There were no additions to intangible assets during the three months ended August 31, 2010. The following tables provide a summary of the carrying amounts of purchased intangible assets that continue to be amortized:

	August 31, 2010			
(in thousands)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Useful Life
Customer relationships	$ 14,920	$ (11,380)	$ 3,540	6.3 Years
Tradenames	820	(752)	68	5.0 Years
Acquired developed technology	5,890	(5,399)	491	5.0 Years
Total	$ 21,630	$ (17,531)	$ 4,099	

	May 31, 2010			
(in thousands)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Useful Life
Customer relationships	$ 14,920	$ (10,787)	$ 4,133	6.3 Years
Tradenames	820	(710)	110	5.0 Years
Acquired developed technology	5,890	(5,105)	785	5.0 Years
Total	$ 21,630	$ (16,602)	$ 5,028	

The total expected future amortization related to acquired intangible assets is approximately $2.3 million and $1.8 million in fiscal years 2011 through 2012, respectively. All intangible assets are expected to be fully amortized by May 31, 2012.

Goodwill is reviewed annually for impairment (or more frequently if indicators of impairment arise or circumstances otherwise dictate). The Company completed its annual impairment assessment in fiscal 2010 and concluded that goodwill was not impaired. For the three months ended August 31, 2010, there were no indicators of impairment of goodwill. Intangible assets are reviewed for impairment whenever events indicate that their carrying amount may not be recoverable. For the three months ended August 31, 2010, there were no indicators of impairment of intangible assets.

7. Lease Obligations

On September 7, 2010, the Company entered into a Third Amendment to Lease with Westport Office Park, LLC (the Landlord), which amends the Lease Agreement dated as of March 16, 1999, as amended, between the Company and the Landlord relating to the lease of the office space comprising the Company s corporate headquarters. The Third Amendment to Lease, which became effective as of August 31, 2010, extended the lease termination date from May 31, 2014 to May 31, 2019. The Third Amendment to Lease also amended the Lease Agreement so that the base monthly rent payable from June 1, 2013 through May 31, 2014 under the Lease

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SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Agreement will be $162,086 and the monthly rent payable from June 1, 2014 through May 31, 2019 under the Lease Agreement will begin at $96,768 on June 1, 2014 and thereafter increase annually by approximately $3,000.

8. Derivative Financial Instruments

Foreign Currency Forward Contracts Not Designated as Hedges

Saba transacts business in various foreign currencies and is subject to risks associated with certain foreign currency exposures. In fiscal 2011, Saba started a program that primarily utilizes foreign currency forward contracts to offset these risks so that increases or decreases in foreign currency exposures are offset by gains or losses on the foreign currency forward contracts in order to mitigate the risks and volatility associated with our foreign currency transactions, specifically with Indian rupee. Saba s currency exposures typically arise from intercompany loans and other intercompany transactions that are expected to be cash-settled in the near term. Saba s ultimate realized gain or loss with respect to currency fluctuations will generally depend on the size and type of cross-currency transactions that are entered into, the currency exchange rates associated with these exposures and changes in those rates, whether Saba has entered into foreign currency forward contracts to offset these exposures and other factors.

Saba neither uses foreign currency forward contracts for trading purposes nor designates these forward contracts as hedging instruments pursuant to ASC 815. Accordingly, the fair values of these contracts are recorded as of the end of the reporting period on the Company s consolidated balance sheet with changes in fair values recorded on the Company s consolidated statement of operations. The balance sheet classification for the fair values of these forward contracts is current liabilities for unrealized losses. The statement of operations classification for the fair values of these forward contracts is interest and other expense, net, for both realized and unrealized gains and losses. In the tables below, Saba provides information related to its foreign currency forward contracts where all of the contracts are not designated as hedges.

The effects of derivative instruments on the Company s condensed consolidated financial statements are as follows as of and for each of the respective periods presented below (amounts presented exclude any income tax effects):

Fair Value of Derivative Instruments in Condensed Consolidated Balance Sheets

		Three months ended August 31, 2010	2009
		(in thousands)	
Derivatives not designated as hedges:			
Foreign currency forward contracts	Current liabilities	$ 96	

		Three months ended August 31, 2010	2009
		(in thousands)	
Derivatives not designated as hedges:			
Foreign currency forward contracts	Interest and other income (expense), net	$ (96)	

9. Guarantees

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

SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Other guarantees include promises to indemnify, defend and hold harmless each of the Company s executive officers, non-employee directors and certain key employees from and against losses, damages and costs incurred by each such individual in administrative, legal or investigative proceedings arising from alleged wrongdoing by the individual while acting in good faith within the scope of his or her job duties on behalf of the Company. Historically, minimal costs have been incurred relating to such indemnifications and, as such, no accruals for these guarantees have been made.

10. Income Taxes

Income tax provision for the three months ended August 31, 2010 and 2009 was an expense of $165,000 and $214,000, respectively. Income tax provision during both of these three-month periods consists primarily of state taxes as well as foreign tax expense incurred as a result of local country profits. The decrease in provision expense for the three months ended August 31, 2010 compared to the three months ended August 31, 2009 is primarily related to the current quarter loss in the US jurisdiction.

As of August 31, 2010 and May 31, 2010, the Company had a valuation allowance against the full amount of any U.S. net deferred tax assets. The Company currently provides a valuation allowance against deferred tax assets when it is more likely than not that some portion, or all of its deferred tax assets, will not be realized.

11. Litigation

Litigation Relating to Initial Public Offering of Saba

In November 2001, a complaint was filed in the United States District Court for the Southern District of New York (the District Court) against the Company, certain of its officers and directors, and certain underwriters of the Company s initial public offering. The complaint was purportedly filed on behalf of a class of certain persons who purchased the Company s common 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, as amended (the Securities Act), Section 10(b) of the Securities Exchange Act of 1934, as amended (the Exchange Act), and other related provisions in connection with certain alleged compensation arrangements entered into by the underwriters in connection with the initial public 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 initial public offering failed to disclose that the underwriters allegedly solicited and received excessive commissions from investors and that some investors in the initial public offering agreed with the underwriters to buy additional shares in the aftermarket in order to inflate the price of the Company s 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, moved to dismiss the litigation. On February 19, 2003, the District Court ruled on the motions. The District Court granted the Company s motion to dismiss the claims against the Company under Rule 10b-5, due to the insufficiency of the allegations against the Company. The District 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.

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(Unaudited)

In June 2003, a proposed collective partial settlement of this litigation was structured between the plaintiffs, the issuer defendants in the consolidated actions, the issuer officers and directors named as defendants, and the issuers insurance companies. In June 2004, an agreement of partial settlement was submitted to the District Court for preliminary approval. The District Court granted the preliminary approval motion on February 15, 2005, subject to certain modifications. On August 31, 2005 the District Court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. The District 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 occurred on April 24, 2006, and the court reserved decision at that time.

While the partial settlement was pending approval, the plaintiffs continued to litigate against the underwriter defendants. The District Court directed that the litigation proceed within a number of focus cases rather than in all of the 310 cases that have been consolidated. The Company s case is not one of these focus cases. On October 13, 2004, the District Court certified the focus cases as class actions. The underwriter defendants appealed that ruling, and on December 5, 2006, the Court of Appeals for the Second Circuit reversed the District Court s class certification decision. On April 6, 2007, the Second Circuit denied plaintiffs petition for rehearing. In light of the Second Circuit opinion, counsel for the issuer defendants informed the District Court that this settlement could not be approved because the defined settlement class, like the litigation class, could not be certified. On June 25, 2007, the District Court entered an order terminating the settlement agreement. On August 14, 2007, the plaintiffs filed their second consolidated amended class action complaints against the focus cases and on September 27, 2007, again moved for class certification. On November 12, 2007, certain of the defendants in the focus cases moved to dismiss the second consolidated amended class action complaints. On March 26, 2008, the District Court denied the motions to dismiss except as to Section 11 claims raised by those plaintiffs who sold their securities for a price in excess of the initial offering price and those who purchased outside the previously certified class period. Briefing on the class certification motion was completed in May 2008. That motion was withdrawn without prejudice on October 10, 2008.

On April 2, 2009, a stipulation and agreement of settlement among the plaintiffs, issuer defendants and underwriter defendants was submitted to the Court for preliminary approval. The Court granted the plaintiffs motion for preliminary approval and preliminarily certified the settlement classes on June 10, 2009. The settlement fairness hearing was held on September 10, 2009. On October 5, 2009, the Court entered an opinion granting final approval to the settlement and directing that the Clerk of the Court close these actions. Notices of appeal of the opinion granting final approval have been filed.

The Company intends to dispute these claims and defend the lawsuit vigorously. However, due to the inherent uncertainties of litigation and because the settlement remains subject to appeal, the ultimate outcome of the litigation is uncertain. An unfavorable outcome in litigation could materially and adversely affect the Company s business, financial condition and results of operations.

Litigation Relating to Centra s Initial Public Offering

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 District Court. 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 complaint filed in April 2002. The action, captioned in re Centra Software, Inc. Initial Public Offering Securities Litigation, No. 01 CV 10988, 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 and Sections 10(b) and 20(a) of the Exchange Act. 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 aftermarket 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

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(Unaudited)

alleged arrangements. The complaint seeks damages in an unspecified amount against Centra and the named individuals. Similar complaints have been filed against hundreds of other issuers that have had initial public offerings since 1998; the complaints have been consolidated into an action captioned in re Initial Public Offering Securities Litigation, No. 21 MC 92.

On July 1, 2002, the underwriter defendants in the consolidated actions moved to dismiss all the actions, including the action involving Centra. On July 15, 2002, Centra, along with other non-underwriter defendants in the coordinated cases, moved to dismiss the litigation. On October 9, 2002, pursuant to agreements tolling the statute of limitations for claims related to the litigation, the plaintiffs dismissed, without prejudice, the claims against the named Centra officers and directors in the above-referenced action. Subsequent addenda to the agreements extended the tolling period through August 27, 2010. On February 19, 2003, the District Court issued an order denying the motion to dismiss the claims against Centra under Rule 10b-5. 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 Centra.

In June 2003, a proposed collective partial settlement of this litigation was structured between the plaintiffs, the issuer defendants in the consolidated actions, the issuer officers and directors named as defendants, and the issuers insurance companies. In June 2004, an agreement of settlement was submitted to the District Court for preliminary approval. The District Court granted the preliminary approval motion on February 15, 2005, subject to certain modifications. On August 31, 2005, the District Court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. The District 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 occurred on April 24, 2006, and the court reserved decision at that time.

While the partial settlement was pending approval, the plaintiffs continued to litigate against the underwriter defendants. The District Court directed that the litigation proceed within a number of focus cases rather than in all of the 310 cases that have been consolidated. The Company s case is not one of these focus cases. On October 13, 2004, the District Court certified the focus cases as class actions. The underwriter defendants appealed that ruling, and on December 5, 2006, the Court of Appeals for the Second Circuit reversed the District Court s class certification decision. On April 6, 2007, the Second Circuit denied plaintiffs petition for rehearing. In light of the Second Circuit opinion, counsel for the issuer defendants informed the District Court that this settlement could not be approved because the defined settlement class, like the litigation class, could not be certified. On June 25, 2007, the District Court entered an order terminating the settlement agreement. On August 14, 2007, the plaintiffs filed their second consolidated amended class action complaints against the focus cases and on September 27, 2007, again moved for class certification. On November 12, 2007, certain of the defendants in the focus cases moved to dismiss the second consolidated amended class action complaints. On March 26, 2008, the District Court denied the motions to dismiss except as to Section 11 claims raised by those plaintiffs who sold their securities for a price in excess of the initial offering price and those who purchased outside the previously certified class period. Briefing on the class certification motion was completed in May 2008. That motion was withdrawn without prejudice on October 10, 2008.

On April 2, 2009, a stipulation and agreement of settlement among the plaintiffs, issuer defendants and underwriter defendants was submitted to the Court for preliminary approval. The Court granted the plaintiffs motion for preliminary approval and preliminarily certified the settlement classes on June 10, 2009. The settlement fairness hearing was held on September 10, 2009. On October 5, 2009, the Court entered an opinion granting final approval to the settlement and directing that the Clerk of the Court close these actions. On August 26, 2010, based on the expiration of the tolling period stated in the agreements between the plaintiffs and the named Centra officers and directors, the plaintiffs filed a notice to terminate the tolling agreement and recommence litigation against the named Centra officers and directors. The plaintiffs stated to the Court that they do not intend to take any further action against the named Centra officers and directors at this time. Notices of appeal of the opinion granting final approval have been filed.

The Company, on behalf of Centra, intends to dispute these claims and defend the lawsuit vigorously.

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(Unaudited)

However, due to the inherent uncertainties of litigation and because the settlement remains subject to appeal, the ultimate outcome of the litigation is uncertain. An unfavorable outcome in litigation could materially and adversely affect the Company s business, financial condition and results of operations.

Litigation Relating to Claim of Patent Infringement by Centra

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 Colorado District Court). 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 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 (the Patent Office). The Company s 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 Colorado District Court approved the parties motion to stay the court proceedings during the re-examination proceedings. A reexamination certificate has been issued for one of the patents that canceled all of the patent s claims, thereby rendering that patent of no further force or effect. The Patent Office issued a reexamination certificate for the other patent canceling all of the patent s original claims and allowing certain newly-added claims. The Company believes that it is free from liability for past actions, as the Company believes the newly-added claims would be enforceable only prospectively as of the issue date of the reexamination certificate. Centra has since filed a second reexamination request asking the Patent Office to reconsider the patentability of the newly-added claims in view of newly-discovered prior art and the Patent Office has granted that request. The Colorado District Court has again stayed the litigation pending the outcome of the second reexamination proceeding. The Company believes that it has meritorious defenses with respect to any future claims and intends to vigorously defend this action. However, due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the litigation. An unfavorable outcome of the litigation could materially and adversely affect the Company s business, financial condition and results of operations.

Litigation Relating to Claim of Patent Infringement by Saba

On November 19, 2007, a complaint was filed against the Company and ten other defendants by Gemini IP, LLC, in the United States District Court for the Eastern District of Texas (No. 07-CV-521) (the Texas District Court). The complaint alleges infringement of a patent directed to a method for processing client help requests using a computer network and seeks permanent injunctive relief against continuing infringement, compensatory damages in an unspecified amount, and interest, costs and expenses associated with the litigation. The Company filed an answer to the complaint denying all of the allegations. At the Company s request, the Patent Office instituted reexamination proceedings against the asserted patent and the Texas District Court stayed the action pending the outcome of those proceedings. On September 14, 2010, the Patent Office issued a Reexamination Certificate cancelling all of the patent s original claims that were asserted against the Company in the litigation. The Reexamination Certificate also includes several new claims that were added during the reexamination proceeding. It is presently unknown whether any of the newly-added claims will be asserted against the Company. The Company believes that it has meritorious defenses with respect to the asserted patent and intends to vigorously defend this action. However, due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the litigation. An unfavorable outcome of the litigation could materially and adversely affect the Company s business, financial condition and results of operations.

12. Recent Accounting Pronouncements

In October 2009, the FASB issued Accounting Standards Update No. 2009-13, Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements (A Consensus of the FASB Emerging Issues Task Force) (ASU 2009-13), which amends existing accounting standards for revenue recognition for multiple-element arrangements.

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(Unaudited)

To the extent a deliverable within a multiple-element arrangement is not accounted for pursuant to other accounting standards, including ASC 985-605, Software-Revenue Recognition, ASU 2009-13 establishes a selling price hierarchy that allows for the use of an estimated selling price to determine the allocation of arrangement consideration to a deliverable in a multiple element arrangement where neither vendor-specific objective evidence nor third-party evidence is available for that deliverable. ASU 2009-13 is to be applied prospectively for revenue arrangements entered into or materially modified in the first quarter of fiscal 2012. The Company is currently evaluating the impact of the pending adoption of ASU 2009-13 on its consolidated financial statements.

In October 2009, the FASB issued Accounting Standards Update 2009-14, *Revenue Recognition (Topic 605) Applicability of AICPA Statement of Position 97-2 to Certain Arrangements That Include Software Elements* (ASU 2009-14). ASU 2009-14 excludes tangible products containing software components and non-software components that function together to deliver the product s essential functionality from the scope of ASC 985-605, *Software-Revenue Recognition*. ASU 2009-14 is required to be applied on a prospective basis to revenue arrangements entered into or materially modified in the first quarter of fiscal 2012. The Company is currently evaluating the impact of the pending adoption of ASU 2009-14 on its consolidated financial statements.

13. Related Party Transactions

During the three months ended August 31, 2010 and 2009, Saba licensed software and sold related support and services to Varian Medical Systems, Inc. (Varian) and Masimo Corporation (Masimo). An Executive Vice President of Varian and the Chairman and Chief Executive Officer of Masimo serve as directors on Saba s Board of Directors.

During the three months ended August 31, 2010 and 2009, the components of related party transactions were as follows:

	Sales to Related Party Three months ended August 31,	
(in thousands)	**2010**	**2009**
Varian Medical Systems, Inc.	$ 56	$ 50
Masimo Corporation		4
Total	$ 56	$ 54

	Accounts Receivable	
(in thousands)	**August 31, 2010**	**May 31, 2010**
Varian Medical Systems, Inc.	$ 32	$ 52
Total	$ 32	$ 52

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ITEM 2: MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the consolidated financial statements and related notes contained herein and the information included in our other filings with the Securities and Exchange Commission. This discussion includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). All statements in this Quarterly Repo