

SABA SOFTWARE INC
Form 10-Q
October 13, 2006
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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, 2006

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

For the transition period from to .

000-30221

(Commission File number)

SABA SOFTWARE, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

2400 Bridge Parkway

94-3267638
(I.R.S. Employer

Identification No.)

94065-1166

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Redwood Shores, California
(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 No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-Accelerated filer

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

On September 30, 2006, 28,500,834 shares of the registrant's Common Stock, \$.001 par value, were outstanding.

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****SABA SOFTWARE, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)

	August 31, 2006 (Unaudited)	May 31, 2006 *
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 19,706	\$ 23,029
Restricted cash	500	500
Accounts receivable, net	23,045	18,993
Prepaid expenses and other current assets	2,694	2,709
Total current assets	45,945	45,231
Property and equipment, net	2,189	2,172
Goodwill	38,136	38,164
Purchased intangible assets, net	19,440	20,449
Other assets	929	1,018
Total assets	\$ 106,639	\$ 107,034
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 6,745	\$ 8,782
Accrued compensation and related expenses	5,601	6,259
Accrued expenses	5,702	6,265
Deferred revenue	23,880	24,230
Current portion of debt and lease obligations	6,278	2,330
Total current liabilities	48,206	47,866
Deferred revenue	2,107	526
Accrued rent	2,807	2,833
Debt and lease obligations, less current portion	3,431	3,962
Total liabilities	56,551	55,187
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, issuable in series: \$0.001 par value: 5,000,000 authorized shares at August 31, 2006 and May 31, 2006; none issued or outstanding		
Common stock, \$0.001 par value: 50,000,000 authorized; 28,584,107 issued and outstanding at August 31, 2006 and 28,509,483 shares issued and outstanding at May 31, 2006	29	29
Additional paid-in capital	248,530	247,716
Treasury stock: 102,997 shares at August 31, 2006 and May 31, 2006, at cost	(232)	(232)
Accumulated deficit	(197,950)	(195,359)

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Accumulated other comprehensive loss	(289)	(307)
Total stockholders' equity	50,088	51,847
Total liabilities and stockholders' equity	\$ 106,639	\$ 107,034

* Derived from audited financial statements as of May 31, 2006.

See Accompanying Notes to Condensed Consolidated Financial Statements.

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

	Three months ended	
	August 31,	
	2006	August 31, 2005
Revenues:		
License	\$ 6,188	\$ 3,350
License updates and product support	7,007	4,363
OnDemand	3,549	838
Professional services	6,415	5,077
Total revenues	23,159	13,628
Cost of revenues:		
Cost of license	215	259
Cost of license updates and product support	1,884	906
Cost of OnDemand	1,142	327
Cost of professional services	4,974	3,809
Amortization of acquired developed technology	294	
Total cost of revenues	8,509	5,301
Gross profit	14,650	8,327
Operating expenses:		
Research and development	4,017	2,727
Sales and marketing	9,364	5,297
General and administrative	2,992	1,636
Amortization of purchased intangible assets	634	170
Total operating expenses	17,007	9,830
Loss from operations	(2,357)	(1,503)
Interest income and other, net	66	(3)
Interest expense	(136)	(108)
Loss before provision for income taxes	(2,427)	(1,614)
Provision for income taxes	164	8
Net loss	\$ (2,591)	\$ (1,622)
Basic and diluted net loss per share	\$ (0.09)	\$ (0.09)
Shares used in computing basic and diluted net loss per share	28,210	17,295

See Accompanying Notes to Condensed Consolidated Financial Statements.

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

	Three months ended	
	August 31,	
	2006	August 31, 2005
Operating activities:		
Net loss	\$ (2,591)	\$ (1,622)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	345	130
Amortization of purchased intangible assets	1,008	195
Stock-based compensation expense	509	
Changes in operating assets and liabilities:		
Accounts receivable	(4,002)	703
Prepaid expenses and other current assets	79	244
Other assets	90	(60)
Accounts payable	(2,060)	(17)
Accrued compensation and related expenses	(660)	(4)
Accrued expenses	(561)	(1,731)
Accrued rent	(26)	(9)
Deferred revenue	1,190	(796)
Net cash used in operating activities	(6,679)	(2,967)
Investing activities:		
Purchases of property and equipment	(363)	(265)
Net cash used in investing activities	(363)	(265)
Financing activities:		
Proceeds from issuance of common stock under employee stock plans	306	181
Borrowings, under credit facility, net of issuance costs	4,000	124
Repayments on borrowings under credit facility	(542)	(661)
Repayments on note payable	(42)	(18)
Net cash provided by (used in) financing activities	3,722	(374)
Effect of exchange rate changes on cash	(3)	
Decrease in cash and cash equivalents	(3,323)	(3,606)
Cash and cash equivalents, beginning of period	23,029	15,408
Cash and cash equivalents, end of period	\$ 19,706	\$ 11,802

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 accompanying unaudited condensed consolidated financial statements include the accounts of Saba Software, Inc. and its wholly owned subsidiaries (Saba or the Company) and, in the opinion of management, reflect all adjustments (consisting only of normal recurring adjustments) necessary to fairly state Saba's consolidated financial position, results of operations, and cash flows as of and for the dates and periods presented.

These unaudited condensed consolidated financial statements should be read in conjunction with Saba's audited condensed consolidated financial statements included in Saba's Annual Report on Form 10-K filed with the Securities and Exchange Commission on August 18, 2006, as amended by the Form 10-K/A filed on September 28, 2006. The results of operations for the three months ended August 31, 2006 are not necessarily indicative of results for the entire fiscal year ending May 31, 2007 or for any future period.

The condensed consolidated balance sheet at May 31, 2006 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

Certain previously reported amounts on the statement of operations have been reclassified to conform to the current presentation, none of which affected gross margin, net loss or net loss per share. Specifically, the Company has reclassified revenues and cost of revenues by type and made certain reclassifications between operating expense accounts.

2. Stock-Based Compensation

The Company currently grants stock options under its 2000 Stock Incentive Plan and its 1997 Stock Option Plan and maintains an employee stock purchase plan. Beginning with its first quarter of fiscal 2007, the Company adopted the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards No. 123 revised 2004 (SFAS 123R), *Share-Based Payment* which replaced Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation* and supersedes Accounting Principles Board (APB) Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees*. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is the vesting period. The Company adopted SFAS 123R using the modified prospective method, under which prior periods are not revised for comparative purposes. The valuation provisions of SFAS 123R apply to new grants and to grants that were outstanding prior to the effective date and are subsequently modified. Estimated compensation for grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation cost estimated for the SFAS 123 pro forma disclosures.

The adoption of SFAS 123R had and will have a material impact on the Company's consolidated results of operations.

Summary of Assumptions

Prior to June 1, 2006, the Company applied the intrinsic value recognition and measurement principles of APB 25, in accounting for stock-based incentives. Accordingly, the Company was not required to record compensation expense when stock options were granted to eligible participants as long as the exercise price was not less than the fair market value of the stock when the option was granted. The Company was also not required to record compensation expense in connection with its 2000 Employee Stock Purchase Plan (ESPP) as long as the purchase price of the stock was not less than 85% of the lower of the fair market value of the stock at the beginning of each offering period or at the end of each purchase period. Effective June 1, 2006, the Company's adoption of the fair value recognition provisions of SFAS 123R, as interpreted by the Securities and Exchange Commission's Staff Accounting Bulletin No. 107 (SAB 107), *Share-Based Payment*, using the modified prospective transition

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method resulting in the recognition of stock-based compensation expense for the three months ended August 31, 2006 which included: (a) compensation expense for all stock-based instruments granted prior to, but not yet vested as of June 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all stock-based instruments granted on or after June 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. Because the Company elected to use the modified prospective transition method, results for prior periods have not been restated.

The Company currently uses the Black-Scholes-Merton option pricing model to determine the fair value of stock options and employee stock purchase plan (ESPP) shares. The determination of the fair value of stock-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 the awards, the Company's expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends. The Company estimates the expected term of stock-based awards granted by applying the simplified method in accordance with SAB 107. The Company estimates the volatility of its common stock based upon 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 stock-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.

Impact of the Adoption of SFAS 123R

The following table summarizes the stock-based compensation expense for stock options and the ESPP shares that was recorded on the Company's results of operations in accordance with SFAS 123R for the three months ended August 31, 2006.

	Three Months
	Ended
	August 31,
	2006
(in thousands, except per share data)	
Cost of revenues	\$ 59
Research and development	79
Sales and marketing	223
General and administrative	148
Stock-based compensation expense included in net loss	\$ 509
Effect of stock-based compensation on net loss per share:	
Basic and diluted	\$ 0.02

Determining Fair Value

The Company used the following assumptions to estimate the fair value of options granted for the three months ended August 31, 2006 and 2005:

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	Three Months Ended	
	August 31, 2006	August 31, 2005
Stock Options:		
Expected volatility	66%	50%
Risk-free interest rates	5%	4%
Expected term (years)	4.1	2.5
Expected dividend yield	0%	0%
Forfeiture rate	25%	38%

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

Price data and activity for the Company's equity compensation plans during the three months ended August 31, 2006, are summarized as follows:

	Outstanding Options (Number of Shares)	Weighted Average Exercise Price Per Share
Balance at May 31, 2006	3,932,104	\$ 5.28
Granted	857,250	\$ 6.37
Exercised	43,374	\$ 4.10
Forfeited or expired	375,930	\$ 8.04
Balance at August 31, 2006	4,370,050	\$ 5.27

The weighted average fair value of options granted during the three months ended August 31, 2006 was \$3.47 per share.

Stock options issued under equity compensation plans outstanding and exercisable at August 31, 2006 were as follows:

Ranges of Exercisable Prices	Options Outstanding			Options Exercisable			
	Shares	Weighted- Average Remaining Contractual Life (Yrs)	Weighted- Average Exercise Price	Aggregate Intrinsic Value	Shares	Weighted- Average Exercise Price	Aggregate Intrinsic Value
\$ 0.02 - \$ 2.52	278,035	2.39	\$ 2.19	\$ 863,110	248,612	\$ 2.15	\$ 781,317
\$ 2.53 - \$ 3.62	67,175	3.76	\$ 3.53	118,228	36,097	\$ 3.53	63,531
\$ 3.63 - \$ 3.63	330,545	2.92	\$ 3.63	548,705	232,835	\$ 3.63	386,506
\$ 3.78 - \$ 3.78	406,000	3.53	\$ 3.78	613,060	236,217	\$ 3.78	356,688
\$ 3.80 - \$ 4.50	1,040,953	4.70	\$ 4.07	1,271,693	307,698	\$ 4.10	366,201
\$ 4.51 - \$ 6.00	1,132,314	5.03	\$ 5.12	271,736	86,815	\$ 4.98	27,269
\$ 6.01 - \$ 7.00	834,312	5.74	\$ 6.40		2,538	\$ 6.60	
\$ 7.01 - \$ 9.00	213,077	1.05	\$ 7.93		212,530	\$ 7.93	
\$ 9.01 - \$ 11.00	14,775	1.84	\$ 10.66		14,264	\$ 10.67	
\$ 11.01 - \$ 117.50	52,864	0.65	\$ 42.18		52,864	\$ 42.18	
\$ 0.02 - \$ 117.50	4,370,050	4.34	\$ 5.27	\$ 3,686,532	1,430,470	\$ 5.72	\$ 1,981,512

The Company defines in-the-money options at August 31, 2006 as options that had exercise prices that were lower than the \$5.29 market price of its common stock at that date. The aggregate intrinsic value of options outstanding at August 31, 2006 is calculated as the difference between the exercise price of the underlying options and the market price of its common stock for the 3.1 million shares that were in-the-money at that date. There were 1.1 million in-the-money options exercisable at August 31, 2006. The total intrinsic value of options exercised during the three months ended August 31, 2006 was \$77,000, determined as of the date of exercise.

The Company recorded \$509,000 in stock-based compensation expense before income tax benefit for stock options and shares granted under its ESPP in its results of operations for the three months ended August 31, 2006. As of August 31, 2006, there was \$3.1 million of total unrecognized compensation cost before income tax benefit related to non-vested stock-based compensation arrangements granted under all

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equity compensation plans. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures. The Company expects to recognize that cost over a weighted average period of 1.8 years.

The Company received \$210,000 in cash from option exercises and \$96,000 from the purchase of shares under the ESPP during the three months ended August 31, 2006. Upon the exercise of options and stock purchase shares granted under the ESPP, the Company issues new common stock from its authorized shares.

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SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Comparable Disclosures

Prior to the Company's adoption of SFAS 123R on June 1, 2006, the Company accounted for stock-based employee compensation under the provisions of APB 25 and had recorded no stock-based compensation expense for the three months ended August 31, 2005. The following table illustrates the effect on the Company's net loss and net loss per share for the three months ended August 31, 2005 had the Company applied the fair value recognition provisions of SFAS 123 to stock-based compensation using the Black-Scholes-Merton valuation model.

	Three Months Ended
	August 31, 2005
Net loss as reported	\$ (1,622)
Less: Pro-forma stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(1,462)
Adjusted net loss	\$ (3,084)
Basic and diluted net loss per share:	
As reported	\$ (0.09)
As adjusted	\$ (0.18)

3. Basic and Diluted Net Loss Per Share

Basic and diluted net loss per share information for all periods is presented under the requirements of Statement of Financial Accounting Standards (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 the weighted-average number of shares that may be repurchased. Basic earnings per share also excludes any dilutive effects of options and warrants as well as any contingently issuable shares in escrow for which specific conditions have not yet been met. Potentially dilutive issuances have been excluded from the computation of diluted net loss per share as their inclusion would be anti-dilutive. The calculations of basic and diluted net loss per share are as follows:

	Three months ended	
	August 31,	August 31,
	2006	2005
Net loss	\$ (2,591)	\$ (1,622)
Weighted-average shares of common stock outstanding	28,210	17,295
Weighted-average shares of common stock used in computing basic and diluted net loss per share	28,210	17,295
Basic and diluted net loss per share	\$ (0.09)	\$ (0.09)

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For the three months ended August 31, 2006 and 2005, 2.0 million and 1.2 million weighted-average potential common shares, respectively, consisting of outstanding options and shares related to the THINQ Learning Solutions, Inc. (THINQ) acquisition, are excluded from the determination of diluted net loss per share, as the effect of such shares is anti-dilutive.

4. Comprehensive Loss

Saba reports comprehensive loss in accordance with SFAS No. 130, Reporting Comprehensive Income. The following table sets forth the calculation of comprehensive loss for all periods presented:

	Three months ended	
	August 31,	August 31,
	2006	2005
Net loss	\$ (2,591)	\$ (1,622)
Foreign currency translation gain (loss)	19	(129)
Comprehensive loss	\$ (2,572)	\$ (1,751)

Table of Contents**SABA SOFTWARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****5. 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 beginning on February 1, 2006. The total preliminary purchase price was \$62.3 million, which consisted of \$37.8 million of Saba common stock, \$19.4 million in cash paid to Centra stockholders and \$5.1 million in cash for transaction costs. In allocating the purchase price based on estimated fair values, Saba recorded approximately \$23.3 million of goodwill, \$18.1 million of identifiable intangible assets and \$20.9 million of net liabilities.

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.

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.

6. Goodwill and Purchased Intangible Assets

Purchased intangible assets consist of intellectual property, customer base and non-competition agreements 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 three to seven years.

There were no additions to intangible assets during the quarter ended August 31, 2006. The following tables provide a summary of the carrying amounts of purchased intangible assets that continue to be amortized:

	August 31, 2006			Weighted
	Gross Carrying Amount	Accumulated Amortization (in thousands)	Net Carrying Amount	Average Useful Life
Customer backlog	\$ 740	\$ (261)	\$ 479	2.4 Years
Customer relationships	14,920	(1,886)	13,034	6.3 Years
Tradenames	820	(96)	724	5 Years
Acquired developed technology	5,890	(687)	5,203	5 Years
Total	\$ 22,370	\$ (2,930)	\$ 19,440	

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	May 31, 2006			Weighted
	Gross Carrying Amount	Accumulated Amortization (in thousands)	Net Carrying Amount	Average Useful Life
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
Total	\$ 22,370	\$ (1,921)	\$ 20,449	

The total expected future amortization related to purchased intangible assets will be approximately \$3,027,000 for the remainder of fiscal 2007 and \$3,955,000, \$3,716,000, \$3,716,000, and \$3,268,000 in fiscal years 2008 through 2011, respectively, and \$1,759,000 thereafter.

Goodwill is reviewed annually for impairment (or more frequently if indicators of impairment arise). The Company completed its annual impairment assessment in fiscal 2006 and concluded that goodwill was not impaired. In the quarter ended August 31, 2006, there were no indicators of impairment of goodwill and intangible assets.

The changes in the carrying amount of goodwill for the three months ended August 31, 2006 are as follows (in thousands):

	Net Carrying Amount
Goodwill, as of May 31, 2006	\$ 38,164
Adjustments to goodwill related to the THINQ and Centra acquisitions	(28)
Goodwill, as of August 31, 2006	\$ 38,136

7. Debt and Other Obligations**Notes Payable and other obligations**

In connection with the acquisition of THINQ in May 2005, Saba assumed a note payable that represented payments due to a former landlord and certain equipment loans. At August 31, 2006 and May 31, 2006, the balance on the note payable was \$108,000 and \$115,000 and the total balance of the equipment loans was \$13,000 and \$19,000, respectively.

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 \$35,000 at August 31, 2006 and \$52,500 at May 31, 2006.

Credit Facility

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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 to replace the existing credit facility. 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 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 bank's interest rate was 8.5% at August 31, 2006. 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

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financial institution, in each case, prior to the second anniversary of the credit facility. As of August 31, 2006 and May 31, 2006, the Company had borrowings under the term portion of the credit facility of \$5.4 million and \$6.0 million, respectively. As of August 31, 2006, the Company had borrowings under the revolving credit line of \$4.0 million and \$3.4 million remained available under the accounts receivable borrowing base portion. As of May 31, 2006, there were no borrowings under this 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 or earnings before income tax, depreciation and amortization, covenant on a quarterly basis and a minimum liquidity covenant on a monthly basis. Under the terms of the agreement, EBITDA 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 August 31, 2006 and 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.

8. 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 were included as part of the Centra preliminary purchase price allocation. The components of accrued restructuring charges and movements within these components through August 31, 2006 for the Centra Restructuring were as follows:

	Workforce Reduction Charges (in thousands)	Facilities Related Charges	Total
Accrual as of May 31, 2006	\$ 927	\$ 593	\$ 1,520
Deductions - cash payments	(278)	(161)	(439)
Accrual as of August 31, 2006	\$ 649	\$ 432	\$ 1,081

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*. The facilities restructuring charges recorded to general and administrative expenses 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. 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 August 31, 2006 for the 2006 Restructuring were as follows:

**Facilities
Related**

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	Charges (in thousands)
Accrual as of May 31, 2006	\$ 458
Deductions cash payments	(152)
Accrual as of August 31, 2006	\$ 306

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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'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.

10. Income Taxes

From inception through August 31, 2006, the Company has incurred net losses for federal and state tax purposes. Income tax expense was \$164,000 during the three months ended August 31, 2006 and \$8,000 during the three months ended August 31, 2005. Income tax expense during both of these periods consists entirely of foreign tax expense incurred as a result of local country profits and tax contingencies.

The tax returns of two 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. The Company will continually review its estimates related to its income tax obligations, including potential assessments of additional taxes, penalties and/or interest, and revise its estimates, if deemed necessary. A revision in the Company's estimates of its tax obligations will be reflected as an adjustment to the income tax provision at the time of the change in the estimates.

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.

11. Segment Information

Saba provides software and services that increase business performance through human capital development and management. Since management's primary form of internal reporting is aligned with the offering of these software products and services, we believe that we operate in one segment for financial reporting purposes.

12. 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 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.

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SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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 occurred on April 24, 2006, and the Court reserved decision. 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.

In December 2001, a complaint was filed in the United States District Court for the Southern District of New York against Centra, certain of its former officers and directors, and the managing underwriters of Centra's initial public offering. The complaint was purportedly filed on behalf of a class of certain persons who purchased Centra's common stock between February 3, 2000 and December 6, 2000. The complaint alleges violations by Centra and its officers and directors of Sections 11 and 15 of the Securities Act, Section 10(b) of the Exchange Act, 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 Centra'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 Centra. On July 15, 2002, Centra, 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 denied Centra's motion to dismiss the claims against it 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. Centra's former officers and directors, Leon Navickas and Stephen A. Johnson, signed tolling agreements and were dismissed from the action without prejudice on October 9, 2002.

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

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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 occurred on April 24, 2006 and the Court reserved decision. 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.

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(Unaudited)

Two individuals in Colorado have excluded themselves from the class action settlement and have each filed individual actions in state court in Colorado. These same individuals have filed similar actions against other issuers and their officers. The actions assert violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as well as common law fraud and intentional infliction of emotional distress. The complaints each seek compensation for a drop in stock price from the time of purchase to the time of sale and for alleged emotional distress. Centra has moved to dismiss the complaints and those motions are pending.

If the settlement process fails, Saba, on behalf of Centra, 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.

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.

13. Recent Accounting Pronouncements

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 Impairment and its Application to Certain Investments*. FSP Nos. FAS 115-1 and FAS 124-1 include guidance for evaluating and 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. The adoption of FSP Nos. FAS 115-1 and FAS 124-1 on June 1, 2006 did not have a material impact on the Company's 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, FIN 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. The Company will adopt FIN 48 in fiscal 2008 and is currently evaluating whether the adoption of FIN 48 will have a material effect on its consolidated financial position, results of operations or cash flows.

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

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SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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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 condensed consolidated financial statements and related notes contained herein and the information included in our annual report on Form 10-K for our fiscal year ended May 31, 2006 and 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 (the Securities Act) and Section 21E of the Securities and Exchange Act of 1934 (the Exchange Act). All statements in this Quarterly Report on Form 10-Q other than statements of historical fact are forward-looking statements for purposes of these provisions, including any statements of the plans and objectives for future operations and any statement of assumptions underlying any of the foregoing. Statements that include the use of terminology such as may, will, expects, believes, plans, estimates, potential, or continue, or the negative thereof or other comparable terminology are forward-looking statements.

Forward-looking statements include statements regarding:

(i) in Part I, Item 1,

future amortization related to intangible assets,

our anticipation that we will not pay any cash dividends in the foreseeable future,

adjustments to total unrecognized compensation costs and recognition of such costs,

our estimates of future sublease income and the estimated payments of such income,

the resolution and effect of pending litigation,

the effect of recent accounting changes,

(ii) in Part I, Item 2,

our belief that the acquisition of Centra helped strengthen our competitive position and allows us to broaden and deepen our product offerings,

our expectation that the Centra product lines and our Saba Performance product will generate a larger percentage of our license sales,

our expectation that the OnDemand line of revenue will become a larger percentage of our total revenue,

our expectation that license updates and product support revenue will increase due to our expanded customer base resulting from the Centra acquisition,

our expectation that a substantial majority of our customers, as well as former Centra customers, will renew their annual contracts and the sale of new licenses will increase the number of customers that purchase license updates and product support,

our belief that many of our customers have not resumed previous levels of expenditures on information technologies, particularly enterprise software,

our need to generate significantly higher revenue and continue to manage our expenses in order to achieve profitability,

continued investment in areas that we believe accelerate growth,

our current plans to implement additional restructuring programs,

adjustments to total unrecognized compensation costs and recognition of such costs,

our anticipation that we will not pay any cash dividends in the foreseeable future,

our expectations that research and development expenses will increase,

our expectations relating to future amortization expenses,

our expectations that we will incur additional liability in connection with the examination of the tax returns of one of our subsidiaries, and our belief that we have provided for adequate tax provisions relating to such examination,

our anticipation that we will continue to experience long sales cycles,

our contractual obligations, including the table summarizing our contractual obligations as of August 31, 2006,

our anticipation that our available cash resources and credit facilities, 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,

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(iii) in Part II, Item 1,

the resolution and effect of pending litigation,
(iv) in Part II, Item 1A,

our expectation that we will derive substantially all of our revenues for the foreseeable future from the licensing of Saba's Human Capital Management software suite, including online learning and collaboration software acquired in connection with the Centra acquisition, and providing related services,

our expectation to continue to incur non-cash expenses relating to the amortization of purchased intangible assets along with any potential goodwill impairment,

our expectation to continue to incur charges related to all current outstanding and future grants of stock options,

our expectation that our operating results will fluctuate significantly in the future,

our expectations to increase our operating expenses to expand our sales and marketing operations, fund greater levels of research and development, develop new alliances, increase our services and support capabilities and improve our operational and financial systems,

our intention to more tightly integrate Centra's products and intellectual property with our products and intellectual property,

our success depending on our ability to attract and retain additional personnel,

our expectation that competition and the pace of change will increase in the future,

our intention to expand our international presence in the future,

our expectation to continue to acquire complementary businesses or technologies,

our expectation to regularly release new products and new versions of our existing products,

our expectations regarding the Edisync Systems litigation,

our anticipation that our available cash resources and credit facilities, 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,

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our belief that our success depends on our proprietary technology, and

our belief that our success depends on the acceptance and successful integration by customers of our products.

These forward-looking statements involve known and unknown risks and uncertainties. Our actual results may differ materially from those projected or assumed in such forward-looking statements. Among the factors that could cause actual results to differ materially are

unanticipated difficulties in integrating Centra's products and intellectual property with Saba's products and intellectual property,

defects and other problems with our products,

unanticipated adverse changes in the international markets,

incorrect estimates or assumptions,

unanticipated adverse results for pending litigation,

contraction of the economy and world markets,

lack of demand for information technologies from our customers,

requirements for increased spending in research and development,

unanticipated need for capital for operations,

lack of demand for our products,

inability to introduce new products, and

the factors detailed under the heading Risk Factors. All forward-looking statements and risk factors included in this document are made as of the date of this report, based on information available to us as of such date. We assume no obligation to update any forward-looking statement or risk factor.

Overview

The following Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is intended to provide readers with an understanding of the Company. The following are included in our MD&A:

Overview of our Business and Industry;

Critical Accounting Policies;

Results of Operations;

Fluctuations of Quarterly Results; and

Liquidity and Capital Resources.

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OVERVIEW OF OUR BUSINESS AND INDUSTRY

Business, Principal Products, and Locations

We are a leading provider of human capital management software and 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 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.

Our solutions help our customers through the implementation of a management system for aligning goals, developing and motivating people and measuring results. By implementing our 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.

On January 31, 2006, we completed the acquisition of Centra, a provider of online learning and training software and services. We believe our acquisition of Centra helped strengthen our competitive position in the human capital management market and allows us to broaden and deepen our product offerings. In addition, as a result of the acquisition our customer base is substantially larger and we have enhanced our global reach and resources, allowing us to better serve our customers.

We license our product and sell our OnDemand services to organizations through a worldwide direct sales force and global network of alliance partners. Our direct sales efforts target large enterprises, including Global 2000 businesses, mid-size organizations and government entities. To date, Saba Enterprise Learning and related services have accounted for a substantial majority of our revenues. Our license revenue is affected by the strength of general economic and business conditions, as well as customers' budgetary cycles and the competitive position of our software products.

Software Licenses

We license our software solutions in multi-element arrangements that include a combination of our software, license updates and product support and/or professional services. A significant amount of our license sales are for perpetual licenses. To date, a substantial majority of our software license revenue has been derived from the Saba Learning product suite. Going forward, we expect the Centra product lines and our Saba Performance product to generate a larger percentage of our license sales. Our license revenue is affected by the strength of general economic and business conditions, as well as customers' budgetary cycles and the competitive position of our software products. In addition, the sales cycle for our products is long, typically six to twelve months. The timing of a few large software license transactions can substantially affect our quarterly license revenue.

OnDemand

OnDemand revenue includes revenue derived from subscription-based managed application services. These services are generally provided pursuant to annual agreements and the associated revenue is recognized ratably over the term of the agreement. With the acquisition of Centra, we believe that this line of revenue will become a larger percentage of our total revenue.

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Licenses Updates and Product Support

License updates and product support includes the right to receive future unspecified updates for the applicable software product and technical support. We typically sell license updates and product support for an initial period of one year concurrently with the sale of the related software license. After the initial period, license updates and product support is renewable on an annual basis at the option of the customer. Our license updates and product support revenue depends upon both our sales of additional software licenses and annual renewals of existing license updates and product support agreements. At the date of the Centra acquisition, we recorded fair value adjustments totaling \$4.7 million, to reduce Centra's license updates and product support obligations to the estimated fair values at the acquisition date. As former Centra customers renew these license updates and product support contracts, we will recognize the full value of the license updates and product support contracts as deferred revenues and recognize the related revenue ratably over the contract period.

We believe that license updates and product support revenue will continue to grow as we anticipate that a substantial majority of our customers, as well as former Centra customers, will renew their annual contracts and the sale of new software licenses will increase the number of customers that purchase license updates and product support

Professional Services

Our professional services business consists of consulting, education and learning services. Consulting and education services are typically provided to customers that license software directly from us. These consulting and education services are generally provided over a period of three to nine months after licensing the software. Generally, consulting services related to software implementation are not considered essential to the functionality of the software. Our consulting and education services revenue varies directly with the levels of license revenue generated from our direct sales organization in the preceding three to nine month period. In addition, our consulting and education services revenue varies following our commercial release of significant software updates as our customers generally engage our services to assist with the implementation of their software update. Although we provide consulting services on a time and materials basis, a significant portion of these services is provided on a fixed fee basis. Learning services are less dependent than consulting and education services on the sale of our licenses. Learning services present additional opportunities that arise at different times throughout a customer life cycle.

Locations

Our corporate headquarters are located in Redwood Shores, California. We have an international presence in India, France, Japan, Germany, the United Kingdom, Canada and Australia through which we conduct various operating activities related to our business. In each of the non-U.S. jurisdictions in which we have subsidiaries, other than India, we have employees or consultants engaged in sales and services activities. In the case of our India subsidiary, our employees primarily engage in software development and quality assurance testing activities.

Significant Trends and Developments in Our Business

Since we commenced operations in 1997 and continuing throughout fiscal 2001, our business grew rapidly. During fiscal 2002 and continuing through the first three quarters of fiscal 2004, our revenues declined as a result of a deterioration in the overall economy and information technology industry. Beginning in the later part of fiscal 2004, many key indicators began to demonstrate signs of an economic recovery. Consistent with these indicators, our business began to improve during the fourth quarter of fiscal 2004 and has generally continued to progress.

Despite these improvements in macro-economic trends, we believe many of our customers have not resumed previous levels of expenditures on information technologies, particularly enterprise software. We attribute this continued level of depressed spending on enterprise software to customers' concerns regarding the sustainability of the current economic recovery and the current geopolitical environment.

In order to achieve profitability, we will need to generate significantly higher revenue and continue to manage our expenses. Our ability to generate higher revenues and achieve profitability depends on many factors, including the demand for our products and services, the level of product and price competition, market acceptance of our new products, general economic conditions and the successful integration of Centra. In this regard, we continue to invest in areas that we believe can accelerate revenue growth and to manage expenses to align our operations and cost structure with market conditions.

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During fiscal 2006 and as a result of our acquisitions of Centra and THINQ, we implemented restructuring programs to consolidate excess facilities. During fiscal 2004, in response to the global economic slowdown, we implemented restructuring programs to reduce expenses to align our operations and cost structure with market conditions and included the consolidation of excess facilities. There were no restructuring programs implemented in fiscal 2005. Although we do not have any current plans to implement additional restructuring programs, business conditions may require us to reduce or otherwise adjust our workforce or consolidate excess facilities in the future.

CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of financial statements in conformity with generally accepted accounting principles requires us 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 revenues and expenses during the reporting periods. Actual results could differ materially from those estimates. We base our estimates and judgments on historical experience and on various other assumptions that we believe are reasonable under the circumstances. However, future events are subject to change and the best estimates and judgments routinely require adjustment. While there are a number of accounting policies, methods and estimates affecting our financial statements, areas that are particularly significant include revenue recognition policies, the allowance for doubtful accounts, the assessment of recoverability of goodwill and purchased intangible assets and restructuring costs. We have reviewed the critical accounting policies described in the following paragraphs with the Audit Committee.

Revenue recognition. We recognize 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, we recognize revenues when all of the following conditions are met:

persuasive evidence of an arrangement 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. We have analyzed each element in our multiple element arrangements and determined that we have 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. We limit our 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. We do not grant our resellers the right of return and we do not recognize revenue from resellers until an end-user has been identified and the other conditions of SOP 97-2 are satisfied. License revenues from licenses with a term of less than three years are generally recognized ratably over the term of the arrangement. License updates and product support revenue is also recognized ratably over the term of the arrangement, typically 12 months.

Revenue related to professional services is generally recognized as the services are performed. Although we provide 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. We use labor hours incurred as a percentage of total expected hours as the measure of progress towards completion.

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Revenue from our 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 our 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*. Our 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, we recognize revenue in accordance with SOP 97-2.

Allowance for doubtful accounts. Accounts receivable are recorded net of allowance for doubtful accounts. The allowance for doubtful accounts is based on our assessment of the collectibility of specific customer accounts and the aging of the accounts receivable. If there is a deterioration of a major customer's credit worthiness or actual defaults are higher than our historical experience, we may be required to increase the allowance for doubtful accounts.

Recoverability of goodwill and purchased intangible assets. Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142) 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. We consider Saba to be a single reporting unit. Accordingly, all of our goodwill is associated with the entire company. We perform the required impairment analysis of goodwill annually, or on an interim basis if circumstances dictate and any reduction of enterprise fair value below the recorded amount of stockholders' equity could require us to write down the value of goodwill and record an expense for an impairment loss. In addition, we evaluated our purchased intangible assets and determined that all such assets have determinable lives.

Restructuring costs. The total accrued restructuring included facilities related charges and workforce reduction charges, some of which was recorded as part of purchase accounting. The assumptions we have made are based on the current market conditions in the various areas where we have vacant space and necessarily entail a high level of management judgment. These market conditions can fluctuate greatly due to factors such as changes in property occupancy rates and rental prices charged for comparable properties. These changes could materially affect our accrual. If, in future periods, it is determined that we have over-accrued for restructuring charges for the consolidation of facilities, the reversal of such over-accrual would have a favorable impact on our results of operations in the period this was determined and may be recorded as a credit to restructuring costs or a decrease of the purchase price. Conversely, if it is determined that our accrual is insufficient, an additional charge would have an unfavorable impact on our results of operations in the period this was determined.

Stock-based compensation. Prior to June 1, 2006, we accounted for our stock-based employee compensation plans under the measurement and recognition provisions of Accounting Principles Board (APB) Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by SFAS No. 123 (SFAS 123), *Accounting for Stock-Based Compensation*. Under APB 25, we generally did not recognize any compensation expense for stock options as the exercise price of our options was equivalent to the market price of our common stock on the date of grant. Additionally, we did not record compensation expense in connection with our employee stock purchase plan as the purchase price of the stock was not less than 85% of the lower of the fair market value of our common stock at the beginning of each offering period or at the end of each purchase period. In accordance with SFAS 123 and SFAS No. 148 (SFAS 148), *Accounting for Stock-Based Compensation: Transition and Disclosure*, we disclosed our net income or loss and net income or loss per share as if we had applied the fair value-based method in measuring compensation expense for our stock-based incentive programs.

Effective June 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123 revised 2004 (SFAS 123R), *Share-Based Payment*, using the modified prospective transition method. Under that transition method, compensation expense that we recognize beginning on that date includes: (a) compensation expense for all stock-based instruments granted prior to, but not yet vested as of, June 1, 2006, based on the grant date fair value

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estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all stock-based instruments granted on or after June 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. Because we elected to use the modified prospective transition method, results for prior periods have not been restated.

We estimate the fair value of options granted in the three months ended August 31, 2006 using the Black-Scholes-Merton option valuation model and the assumptions shown in Note 2 to the condensed consolidated financial statements, Part I, Item 1. We estimate the expected term of stock-based awards granted by applying the simplified method in accordance with SAB 107. We estimate the volatility of our common stock by using our historical stock price volatility over the length of the expected term of the options. We base the risk-free interest rate that we use in the option valuation model on U.S. Treasury zero-coupon issues with remaining maturities similar to the expected term of the options. We have never paid any cash dividends on our common stock and we do not anticipate paying any cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero in the Black-Scholes-Merton option valuation model. SFAS 123R requires us to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. We amortize the fair value of stock based compensation on a straight-line basis. All options are amortized over the requisite service periods of the awards, which are generally the vesting periods.

Recent Accounting Pronouncements

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 Impairment and its Application to Certain Investments*. FSP Nos. FAS 115-1 and FAS 124-1 include guidance for evaluating and 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-temporarily 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. The adoption of FSP Nos. FAS 115-1 and FAS 124-1 on June 1, 2006 did not 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, FIN 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.

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

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

Table of Contents**RESULTS OF OPERATIONS****THREE MONTHS ENDED AUGUST 31, 2006 AND 2005**

On January 31, 2006, we completed the acquisition of Centra Software, Inc. and have included Centra's results of operations from the date of acquisition in our condensed consolidated financial statements. Our results of operations and related discussions for the three months ended August 31, 2005 do not include revenues or expenses related to Centra as that period was prior to the acquisition date. Accordingly, the acquisition had a significant impact on our year over year growth rates. Our acquisition of Centra did not result in any new reportable segments.

Revenues

	Three months ended		Percent	
	August 31,	of Total	August 31,	of Total
	2006	Revenue	2005	Revenue
	(dollars in thousands)			
Revenues:				
License	\$ 6,188	27%	\$ 3,350	25%
License updates and product support	7,007	30%	4,363	32%
OnDemand	3,549	15%	838	6%
Professional services	6,415	28%	5,077	37%
Total revenues	\$ 23,159	100%	\$ 13,628	100%

Total Revenues. Total revenues increased by \$9.5 million, or 70%, during the three months ended August 31, 2006 compared to the three months ended August 31, 2005. As a percentage of total revenues, revenues from customers outside the United States represented 28 % for the three months ended August 31, 2006 and 30% for the three months ended August 31, 2005.

License Revenue. License revenue increased by \$2.8 million, or 85%, during the three months ended August 31, 2006 compared to the three months ended August 31, 2005. The increase in license revenue was primarily attributable to the continued increase in sales activity of our Human Capital Management products, including new products acquired in the Centra acquisition, to new and existing customers.

License Updates and Product Support Revenue. License updates and product support revenue increased by \$2.6 million, or 61%, during the three months ended August 31, 2006 compared to the three months ended August 31, 2005. The increase was primarily attributable to the continued growth in our installed base, both organically as well as from the addition of the Centra and THINQ installed base of customers. The results for the three months ended August 31, 2005 did not include results from Centra as it was acquired on January 31, 2006 and included the fair value adjustment of the THINQ deferred revenue required by GAAP purchase accounting.

OnDemand Revenue. OnDemand revenue increased by \$2.7 million, or 324%, during the three months ended August 31, 2006 compared to the three months ended August 31, 2005. The increase was due primarily to an increase in customer demand for these offerings from both existing and new customers and the inclusion of the Centra OnDemand offerings.

Professional Services Revenue. Professional services revenue increased by \$1.3 million, or 26%, during the three months ended August 31, 2006 compared to the three months ended August 31, 2005. The increase in services revenue during the three months ended August 31, 2006 is primarily attributable to an increase in the number of consulting projects resulting from the increase in the number of new license sales during fiscal 2006 and in part from the overall increase in the customer base.

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

Table of Contents**Cost of Revenues**

	Three months ended		Percent	
	August 31,	of Total	August 31,	of Total
	2006	Revenue	2005	Revenue
(dollars in thousands)				
Cost of revenues:				
Cost of license	\$ 215	1%	\$ 259	2%
Cost of license updates and product support	1,884	8%	906	7%
Cost of OnDemand	1,142	5%	327	2%
Cost of professional services	4,974	22%	3,809	28%
Amortization of acquired developed technology	294	1%		%
Total cost of revenues	\$ 8,509	37%	\$ 5,301	39%

The following table is the summary of gross margin:

	Three months ended	
	August 31,	August 31,
	2006	2005
Gross margin:		
License (including amortization of acquired developed technology)	\$ 5,679	\$ 3,091
<i>Percentage of license revenue</i>	92%	92%
License updates and product support	5,123	3,457
<i>Percentage of license updates and product support revenue</i>	73%	79%
OnDemand	2,407	511
<i>Percentage of OnDemand revenue</i>	68%	61%
Professional services	1,441	1,268
<i>Percentage of professional services revenue</i>	23%	25%
Total	\$ 14,650	\$ 8,327
<i>Percentage of total revenues</i>	63%	61%

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 decreased \$44,000, or 17%, during the three months ended August 31, 2006 when compared to the three months ended August 31, 2005. The decrease was primarily attributable to a decrease in third party product costs related to THINQ products, partially offset by an increase in amortization of prepaid royalties related to the products acquired through the acquisition of 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 \$978,000, or 108%, during the three months ended August 31, 2006 when compared to the three months ended August 31, 2005. The increase is primarily due to the cost to support the license updates and product support contracts assumed in the Centra acquisition, as well as additional investment in our license updates and product support organization, mainly headcount, 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 79% in the first quarter of fiscal 2006 to 73% in the first quarter of fiscal 2007. The decline in gross margin was primarily the result of contracts assumed in the Centra acquisition for which we incurred costs to provide the contracted services without the ability to recognize 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.

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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 \$815,000, or 249%, during the three months ended August 31, 2006

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compared to the three months ended August 31, 2005. The increase in the cost of OnDemand revenue was primarily due to an increase in third party co-location and connectivity fees, an increase in salary and related expenses due to additional headcount and an increase in depreciation expense for OnDemand infrastructure equipment resulting from our investment in the infrastructure to support our increasing revenue base during fiscal 2006. The OnDemand gross margins experienced an increase in the first quarter of fiscal 2007 compared to the first quarter of fiscal 2006, due primarily to the growing user base and higher margin OnDemand offerings.

Cost of Professional Services Revenue. Our cost of professional services revenue includes salaries and related expenses for our professional services, as well as third-party subcontractors and billed expenses. For the three months ended August 31, 2006, cost of services revenue increased \$1.2 million, or 31%, compared to the three months ended August 31, 2005. The increase was primarily attributable to an increase in employee payroll and related expenses and third party consulting fees required to support the increased professional services revenue and meet our customer's demands. The professional services gross margins decreased from 25% in the first quarter of fiscal 2006 to 23% in the first quarter of fiscal 2007. This decrease is primarily attributable to creating a reserve allowance for professional services revenue.

Operating Expenses

We classify all operating expenses, except amortization of purchased intangible assets, 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, stock-based compensation, 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 allowance for doubtful accounts and administrative and professional services fees. Certain reclassifications to the statement of operations have been made to the first quarter of fiscal 2006 amounts in order to conform to the fiscal 2007 presentation, none of which affected gross margin, net loss or net loss per share.

	Three months ended		Percent	
	August 31,	of Total	August 31,	of Total
	2006	Revenue	2005	Revenue
	(dollars in thousands)			
Operating expenses:				
Research and development	\$ 4,017	17%	\$ 2,727	20%
Sales and marketing	9,364	40%	5,297	39%
General and administrative	2,992	13%	1,636	12%
Amortization of purchased intangible assets	634	3%	170	1%
Total operating expenses	\$ 17,007	73%	\$ 9,830	72%

Research and development. Research and development expenses increased \$1.3 million, or 47%, for the three months ended August 31, 2006 compared to the three months ended August 31, 2005. The increase was primarily due to an increase in employee payroll and related benefits expenses of \$1.1 million (including stock-based compensation expense of \$79,000 resulting from the adoption of SFAS 123R), in part as a result of the acquisition of Centra in January 2006. We expect research and development expenses to increase in the foreseeable future.

Sales and marketing. Sales and marketing expenses increased \$4.1 million, or 77%, for the three months ended August 31, 2006 compared to the three months ended August 31, 2005. These increases were primarily attributable to an increase in employee salary and benefits expenses of \$3.4 million (including stock-based compensation expense of \$222,000 resulting from the adoption of SFAS 123R), in part as a result of the acquisition of Centra in January 2006. The increase in salary and benefits expenses also included an increase in commissions of \$1.1 million due to the Company's higher revenue.

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General and administrative. General and administrative expenses increased \$1.4 million, or 83%, for the three months ended August 31, 2006 compared to the three months ended August 31, 2005. The increase is due to increases in employee salary and benefits expenses of approximately \$933,000 (including stock-based compensation expense of \$148,000 resulting from the adoption of SFAS 123R), in part as a result of an increase in headcount related to the acquisition of Centra.

Amortization of purchased intangible assets. Amortization of purchased intangible assets for the three months ended August 31, 2006 increased by \$464,000, or 273%, from the three months ended August 31, 2005 and is primarily attributable to the increase in intangible assets acquired as a result of the acquisition of Centra in January 2006. Future amortization expense over each of the next five years is currently expected to be approximately \$3.0 million for the remainder of fiscal 2007 and range from \$4.0 million in fiscal 2008 to \$1.8 million in fiscal 2012. We periodically review our intangible assets and the estimated remaining useful lives of those intangible assets for impairment. Any impairment or reduction in our estimate of remaining useful lives could result in increased amortization expense in future periods.

Interest income and other, net. Interest income and other, net consists of interest income and other non-operating expenses. Interest income and other, net increased to \$66,000 during the three months ended August 31, 2006 compared to a net expense of \$3,000 during the three months ended August 31, 2005. This increase was primarily attributable to a decrease in foreign exchange losses resulting from more favorable fluctuations in foreign currency denominated payables as well as to an increase in interest income, primarily from higher balances of cash held by the Company.

Interest expense Interest expense was \$136,000 for the three months ended August 31, 2006 and \$108,000 for the three months ended August 31, 2005. The increase in interest expense during the first quarter of fiscal 2007 compared to the first quarter of fiscal 2006 was primarily due to the interest related to the average debt outstanding and interest rates charged under the bank credit facility.

Provision for income taxes From inception through August 31, 2006, we have incurred net losses for federal and state tax purposes. Income tax expense was \$164,000 during the three months ended August 31, 2006 compared to \$8,000 during the three months ended August 31, 2005. Income tax expense during both of these periods consists entirely of foreign tax expense incurred as a result of local country profits and tax contingencies.

The tax returns of two 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 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.

FLUCTUATIONS OF QUARTERLY RESULTS

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 predict revenues between quarters.

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

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;

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

variability in the mix of our products and services revenues in any quarter;

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

foreign currency fluctuations; and

our ability to integrate operations from acquisitions successfully.

LIQUIDITY AND CAPITAL RESOURCES

	Three months ended	
	August 31,	August 31,
	2006	2005
Cash used in operating activities	\$ (6,679)	\$ (2,967)
Cash used in investing activities	\$ (363)	\$ (265)
Cash provided by (used in) financing activities	\$ 3,722	\$ (374)

We have funded our operations primarily through our operations and 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. As of August 31, 2006, we had \$19.7 million in available cash and cash equivalents.

Cash Used In Operating Activities

Cash used in operating activities during the first quarter of fiscal 2007 was \$6.7 million compared to \$3.0 million during the first quarter of fiscal 2006. Cash used in operating activities during the three months ended August 31, 2006 was primarily attributable to a net loss of \$2.6 million, an increase in accounts receivable of \$4.0 million and a decrease in accounts payable of \$2.1 million, partially offset by depreciation and amortization of purchased intangible assets of \$1.4 million and an increase in deferred revenue of \$1.2 million. This compares to a net loss of \$1.6 million, decreases in accrued expenses of \$1.7 million and deferred revenue of 796,000, partially offset by a decrease in accounts receivable of \$703,000 during the three months ended August 31, 2005.

Cash Used In Investing Activities

Cash used in investing activities during the three months ended August 31, 2006 was \$363,000 compared to cash used in investing activities of approximately \$265,000 for the three months ended August 31, 2005 and are wholly attributable to the purchases of property and equipment to support our increased headcount.

Cash Provided By (Used In) Financing Activities

Cash provided by financing activities of \$3.7 million during the three months ended August 31, 2006 was primarily attributable to borrowings under our line of credit of \$4.0 million, partially offset by repayments on our credit facility of \$542,000. Cash used in financing activities of \$374,000 during the three months ended August 31, 2005 was primarily attributable to repayments for term loans of approximately \$661,000 offset by proceeds from borrowings under our credit facility of \$124,000 and from the issuance of common stock under our employee stock plans of \$181,000.

Contractual Obligations and Commitments

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As of August 31, 2006, there were no material changes in our long-term debt obligations, capital leases, operating lease obligations, purchase obligations or any other long-term liabilities reflected on our condensed consolidated balance sheets as compared to such obligations and liabilities as of May 31, 2006. At August 31, 2006, we did not have any material commitments for capital expenses or significant commitments to purchase obligations for goods or services.

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The following table summarizes our contractual obligations at August 31, 2006 and the effect these obligations are expected to have on our liquidity and cash flows in future periods. Of the \$23.1 million in operating leases, \$334,000, which is net of estimated sublease income of \$515,000, is included in accrued restructuring charges as of August 31, 2006.

	Total	Year Ending May 31,					Thereafter
		2007	2008	2009	2010	2011	
Contractual obligations:							
Bank line of credit	\$ 4,000	\$ 4,000	\$	\$	\$	\$	\$
Long-Term debt obligations	5,709	1,729	2,265	1,694	21		
Operating lease obligations	23,086	3,062	3,916	2,608	2,526	2,613	8,361
Other long-term liabilities	989	544	130	105	105	105	
Total	\$ 33,784	\$ 9,335	\$ 6,311	\$ 4,407	\$ 2,652	\$ 2,718	\$ 8,361

We currently anticipate that our available cash resources and credit facilities, 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 August 31, 2006, we did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

ITEM 3. 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 bank's prime rate was 8.5% at August 31, 2006. 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

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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 August 31, 2006, we had \$5.4 million outstanding under the term loan, \$4.0 million outstanding borrowings under the receivables borrowing base revolving credit line and were in compliance with all of the covenants related to this credit facility and expect to be in compliance for the remainder of fiscal 2007.

At August 31, 2006, we had cash and cash equivalents totaling \$19.7 million. Of this amount, approximately \$10.1 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

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.

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 the three months ended August 31, 2006, our total realized and unrealized losses due to movements in foreign currencies, primarily British pounds, Japanese yen and Australia dollars, was \$31,000. 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.

ITEM 4. CONTROLS AND PROCEDURES

As of August 31, 2006, our management evaluated, under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of the design and operation of our disclosure controls and procedures. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in this report. There has been no change in our internal control over financial reporting that occurred during the fiscal quarter ended August 31, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In November 2001, a complaint was filed in the United States District Court for the Southern District of New York against us, certain of our officers and directors, and certain underwriters of our initial public offering. The complaint was purportedly filed on behalf of a class of certain persons who purchased our common stock between April 6, 2000 and December 6, 2000. The complaint alleges violations by us and our officers and directors of Section 11 of the Securities Act, Section 10(b) of the Exchange Act, 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 us. On July 15, 2002, we, 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 our motion to dismiss the claims against us 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, our Chief Executive Officer and Chairman of the Board and our former Chief Financial Officer and a member of our 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 us.

On July 16, 2003, a committee of our 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 us and of the individual defendants for the conduct alleged in the action to be wrongful in the amended complaint. We would agree to undertake other responsibilities under the partial settlement, including agreeing to assign away, not assert, or release certain potential claims we may have against our underwriters. Any direct financial impact of the proposed settlement is expected to be borne by our 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 occurred on April 24, 2006, and the Court reserved decision. 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, we intend to dispute these claims and defend the law suit vigorously. However, due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the litigation. An unfavorable outcome in litigation could materially and adversely affect our business, financial condition and results of operations.

In December 2001, a complaint was filed in the United States District Court for the Southern District of New York against Centra, certain of its former officers and directors, and the managing underwriters of Centra's initial public offering. The complaint was purportedly filed on behalf of a class of certain persons who purchased Centra's common stock between February 3, 2000 and December 6, 2000. The complaint alleges violations by Centra and its officers and directors of Sections 11 and 15 of the Securities Act, Section 10(b) of the Exchange Act, 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 Centra'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 Centra. On July 15, 2002, Centra, 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 denied Centra's motion to dismiss the claims against it 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. Centra's former officers and directors, Leon Navickas and Stephen A. Johnson, signed tolling agreements and were dismissed from the action without prejudice on October 9, 2002.

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

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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 occurred on April 24, 2006 and the Court reserved decision. 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.

Two individuals in Colorado have excluded themselves from the class action settlement and have each filed individual actions in state court in Colorado. These same individuals have filed similar actions against other issuers and their officers. The actions assert violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as well as common law fraud and intentional infliction of emotional distress. The complaints each seek compensation for a drop in stock price from the time of purchase to the time of sale and for alleged emotional distress. Centra has moved to dismiss the complaints and those motions are pending.

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

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.

We are 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 our 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 us.

ITEM 1A. RISK FACTORS

We have a history of losses, expect future losses and cannot assure you that we will achieve profitability on a consistent basis.

We expect to derive substantially all of our revenues for the foreseeable future from the licensing of Saba's Human Capital Management (HCM) software suite, including online learning and collaboration software acquired in connection with the acquisition of Centra in January 2006, and providing related services. We cannot be certain that we will realize sufficient revenues to achieve or sustain profitability. In the future, we expect to continue to incur non-cash expenses relating to the amortization of purchased intangible assets that will contribute to our net losses, along with any potential goodwill impairment. As of August 31, 2006, we had \$19.4 million of purchased intangible assets to be amortized as a result of our January 2006 acquisition of Centra and May 2005 acquisition of THINQ and our remaining goodwill balance was \$38.2 million. Further, starting with this first quarter of fiscal 2007, we recorded stock-based compensation expenses of \$509,000 in our reported results from operations in accordance with SFAS 123R, which was issued by the FASB in December 2004 and will continue to record these charges in future periods. This will make it significantly more difficult for us to achieve profitability and as a result, we expect to incur losses for the foreseeable future. We will need to generate significantly higher revenues and manage expenses in order to achieve profitability or control negative cash flows. If we achieve profitability, we may not be able to sustain it on a consistent basis.

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Fluctuations in our quarterly results could cause our stock price to experience significant fluctuations or declines.

Our operating results have varied significantly in the past and will likely fluctuate significantly in the future. For instance, in fiscal 2006, 2005 and 2004, our quarterly revenues have fluctuated between approximately \$23.2 million and \$7.8 million and our quarterly net income (loss) fluctuated between approximately \$131,000 and \$(5.9) million. Our quarterly operating results are particularly affected by the number of customers licensing our products during any quarter and the size of such licensing transactions. We have limited visibility into our future revenue, especially license revenue, which often has been heavily concentrated in the third month of each quarter. As a result, if we were to fail to close a sufficient number of transactions at the end of our quarter, particularly large license transactions, we would miss our revenue projections. In addition, since we forecast our expenses based in part on future revenue projections, our operating results would be adversely affected if we cannot meet those revenue projections.

Other factors that could affect our quarterly operating results include:

The demand for our products and professional services and our efficiency in rendering our professional services;

The variability in the mix of our revenues in any quarter;

The variability in the mix of the type of services delivered in any quarter and the extent to which third party contractors are used to provide such services;

The size and complexity of our license transactions and potential delays in recognizing revenue from license transactions;

The amount and timing of our operating expenses and capital expenditures;

The performance of our international business, which accounts for a substantial part of our consolidated revenues; and

Fluctuations in foreign currency exchange rates.

Due to these and other factors, we believe that quarter-to-quarter comparisons of our revenues and operating results are not necessarily meaningful and should not be relied upon as indicators of future performance. It is possible that in some future quarter our operating results may be below the expectations of public market analysts or investors, which could cause the market price of our common stock to fall.

Our operating expenses are based on our expectations of future revenues and are relatively fixed in the short-term. During fiscal 2006, fiscal 2004 and fiscal 2003, we took actions to reduce our operating expenses and, while we may from time to time reduce operating expenses in response to variability in our revenues, including variability caused by downturns in the United States and/or international economies, over the long term, we generally expect to increase our operating expenses to expand our sales and marketing operations, fund greater levels of research and development, develop new alliances, increase our services and support capabilities and improve our operational and financial systems. If our revenues do not increase along with these expenses, our business would be seriously harmed and net losses in a given quarter would be even larger than expected. We may undertake future restructuring to align such expenses with revenues.

A decline in the price of, or demand for, our products or our related services offerings, would seriously harm our revenues and operating margins.

To date, Saba Enterprise Learning and related services have accounted for a substantial majority of our revenues. We anticipate that revenues from Saba Enterprise Learning and Centra's software, as well as related services, will continue to constitute a substantial majority of our revenues for the foreseeable future. Consequently, a decline in the price of, or demand for, Saba Enterprise Learning or Centra's software or failure to achieve broad market acceptance would seriously harm our business. If our new products, including Saba Enterprise Performance, fail

to achieve market acceptance, our reliance on Saba Enterprise Learning and Central's software will deepen.

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Our products have a long sales cycle, which increases the cost of completing sales and renders completion of sales less predictable.

The period between our initial contact with a potential customer and the purchase of our products and services is often long. A customer's decision to purchase our products and services requires the commitment to increase performance through human capital management, involves a significant allocation of resources, and is influenced by a customer's budgetary cycles. To successfully sell our products and services, we generally must educate our potential customers regarding the use and benefits of our products and services. We may commit a substantial amount of time and resources to potential customers without assurance that any sales will be completed or revenues generated. Many of our potential customers are large enterprises that generally take longer to make significant business decisions. Our public sector customers, in particular, are subject to extensive procurement procedures that require many reviews and approvals. Our typical sales cycle has been approximately six to 12 months, making it difficult to predict the quarter in which we may recognize revenue. The delay or failure to complete sales in a particular quarter could reduce our revenues in that quarter. If our sales cycle were to unexpectedly lengthen in general or for one or more large orders, it would adversely affect the timing of our revenues. If we were to experience a delay on a large order, it could harm our ability to meet our forecasts for a given quarter.

Our performance depends on a new market: human capital management.

The market for software solutions that automate human capital management is at an early stage of development and rapidly evolving. Substantially all of our revenues are attributable to the suite of products and services in this market. If this market fails to develop or develops more slowly than we expect, our business would be harmed. If the market grows, the prices of our products may decline rapidly as alternative products are introduced into the market. In addition, our products may become obsolete if we fail to anticipate or adapt to evolving technology standards, or if we fail to identify the challenges and risks in this new market or successfully address these risks.

The Centra acquisition may result in dilution of future earnings per share.

The Centra acquisition may not result in improved earnings per share for us or a financial condition superior to that which would have been achieved by us on a stand-alone basis. The acquisition could fail to produce the benefits that we anticipate, or could have other adverse effects that we do not foresee. In addition, some of the assumptions that we have made, such as the achievement of operating synergies, may not be realized. In this event, the merger could result in a reduction of earnings per share for us as compared to the earnings per share that would have been achieved by us if the merger had not occurred.

Under SFAS No. 142, *Goodwill and Other Intangible Assets* purchased goodwill should not be amortized, but rather, should be periodically reviewed for impairment. Such impairment could be caused by internal factors as well as external factors beyond our control. If future events cause additional impairment of any intangible assets acquired in the Centra acquisition or any other of our past or future acquisitions, we may have to record charges relating to such assets sooner than we expect which would cause our profits to decline. The FASB has further determined that at the time goodwill is considered impaired, an amount equal to the impairment loss should be charged as an operating expense in the statement of operations. The timing of such an impairment (if any) of goodwill acquired in past and future transactions is uncertain and difficult to predict. Our results of operations in periods following any such impairment could be materially adversely affected. We are required to determine whether goodwill and any assets acquired in past acquisitions have been impaired in accordance with FAS 142 and, if so, charge such impairment as an expense. We have goodwill of approximately \$38.2 million at August 31, 2006, so if we are required to take such impairment charges in the future, the amounts could have a material adverse effect on our results of operations.

We experience seasonality in our sales, which could cause our quarterly operating results to fluctuate from quarter to quarter.

We experience quarterly seasonality in the licensing of our products and delivery of our services. For example, revenue has historically been lower in our first fiscal quarter than in the immediately preceding fourth fiscal quarter. Contributing to this seasonality is the timing of our first fiscal quarter that occurs during the summer months when

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general business activities slow down in a number of territories where we conduct our operations, particularly Europe. Our commission structure and other sales incentives also tend to result in fewer sales in the first fiscal quarter than in the fourth fiscal quarter. These seasonal variations in our revenue are likely to lead to fluctuations in our quarterly operating results.

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

While we believe that we are in compliance with Statement of Position 97-2, *Software Revenue Recognition*, as amended, the American Institute of Certified Public Accountants continues to issue implementation guidelines for these standards and the accounting profession continues to discuss a wide range of potential interpretations. Additional implementation guidelines, and changes in interpretations of such guidelines, could lead to unanticipated changes in our current revenue accounting practices that could cause us to defer the recognition of revenue to future periods or to recognize lower revenue.

Failure to achieve and maintain effective internal controls could have a material adverse effect on our business, operating results and stock price.

We are in the process of documenting and testing our internal control procedures in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act, which requires an annual management assessment of the design and effectiveness of our internal controls over financial reporting and a report by our Independent Registered Public Accounting Firm addressing this assessment. 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. During the course of our testing we may identify significant deficiencies or material weaknesses which we may not be able to remediate prior to our fiscal year end. In addition, if we fail to achieve and maintain the adequacy of our internal controls, as such standards are modified, supplemented or amended from time to time, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal controls over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act. Moreover, effective internal controls are necessary for us to produce reliable financial reports and are important to helping prevent financial fraud. If we cannot provide reliable financial reports or prevent fraud, our business and operating results could be harmed, investors could lose confidence in our reported financial information, and the trading price of our stock could drop significantly.

The loss of our senior executives and key personnel would likely cause our business to suffer.

Our ability to implement a successful long-term strategy, strengthen our competitive position, expand our customer base, and develop and support our products depends to a significant degree on the performance of the senior management team and other key employees, including Bobby Yazdani, our CEO. The loss of any of these individuals could harm our business. Our success will depend in part on our ability to attract and retain additional personnel with the highly specialized expertise necessary to generate revenue and to engineer, design and support our products and services. Like other software companies, we face intense competition for qualified personnel. We may not be able to attract or retain such personnel.

Intense competition in our target market could impair our ability to grow and achieve profitability on a consistent basis.

The market for our products and services is intensely competitive, dynamic and subject to rapid technological change. The intensity of the competition and the pace of change are expected to increase in the future. Increased competition is likely to result in price reductions, reduced gross margins and loss of market share, any one of which could seriously harm our business. Competitors vary in size and in the scope and breadth of the products and services offered. We encounter competition with respect to different aspects of our solution from a variety of sources including:

Companies that offer training, learning, performance, content, resource, talent and staffing management systems, such as SAP, Oracle, SumTotal and other private companies;

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Companies that offer collaboration solutions, such as Microsoft or WebEx;

Enterprise software vendors that offer human resources information systems and employee relationship management systems with training and performance modules;

Potential customers' internal development efforts;

Companies that operate Internet-based marketplaces for the sale of on-line learning; and

Internet portals that offer learning content, performance support tools or recruiting, talent and staffing management services.

We expect competition from a variety of companies.

Many of our competitors have longer operating histories, substantially greater financial, technical, marketing or other resources, or greater name recognition than we do, enabling them to respond more quickly than we can to new or emerging technologies and changes in customer requirements. Such resources also enable our competitors to withstand prolonged periods of negative cash flows and unfavorable economic, political and market conditions. Competition could seriously impede our ability to sell additional products and services on terms favorable to us. Our current and potential competitors may develop and market new technologies that render our existing or future products and services obsolete, unmarketable or less competitive. Our current and potential competitors may make strategic acquisitions or establish cooperative relationships among themselves or with other partners, thereby increasing the availability of their services to address the needs of our current and prospective customers. We may not be able to compete successfully against our current and future competitors, and competitive pressures that we encounter may seriously harm our business.

If we are unable to manage the complexity of conducting business globally, our international revenues may suffer.

International revenues accounted for 28%, 28% and 42% of our revenues for our first quarter of fiscal 2007 and for our fiscal years ended May 31, 2006 and 2005, respectively. Although we intend to continue to expand our international presence, in the future we may not be able to successfully market, sell or distribute our products and services in foreign markets. The reallocation of certain design, development and testing functions from the United States to our lower-cost development center in India intensifies our exposure to international uncertainties. Factors that could materially adversely affect our international operations, and our business and future growth include:

Difficulties in staffing and managing foreign operations, including language barriers;

Difficulties in maintaining control over product development and quality, and timing of product releases;

Seasonal fluctuations in purchasing patterns in other countries, particularly declining sales during July and August in European markets;

Difficulties in collecting accounts receivable in foreign countries, particularly European countries in which collections take considerably more time than the United States and collections are more difficult to effect;

Currency exchange rate fluctuations, particularly in countries where we sell our products in denominations other than U.S. dollars, such as in the United Kingdom, the Euro zone, Australia and Japan, or have exposures in inter-company accounts denominated in foreign currencies;

Exposure to tax regimes of multiple countries and potential increased tax exposure relating to in-country profits as well as audits and assessments relating to transfer pricing matters;

Costs attributable to development of internationalized versions of our products and marketing and sales materials;

The burdens of complying with a wide variety of foreign laws and reduced protection for intellectual property rights in some countries;

Tariffs, export controls and other trade barriers; and

Exposure to geopolitical instability, natural disasters and acts of war or terrorism.

If we are not successful in integrating Centra, the anticipated benefits of the acquisition may not be realized.

Achieving the anticipated benefits of the acquisition will depend, in part, on the integration of technology, operations and personnel of us and Centra. We cannot assure that the integration will be successful or that the anticipated benefits of the acquisition will be fully realized. The challenges involved in this integration include the following:

Satisfying the needs of the combined company's customers in a timely manner;

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Persuading our employees and the former employees of Centra that we retained that Centra's former business culture is compatible with our business culture, and retaining the combined company's key personnel;

Realizing anticipated cost synergies within the expected time period;

Maintaining the dedication of our management resources to integration activities without diverting attention from the day-to-day business of the combined company;

Maintaining our management's ability to focus on anticipating, responding to or utilizing changing technologies in our and Centra's industry;

Maintaining our and Centra's former key supplier relationships; and

Competing with the introduction of new, disruptive technologies to the marketplace which could reduce our market share prior to the successful integration of Centra.

In addition, we intend to more tightly integrate Centra's products and intellectual property with our products and intellectual property. This may result in longer product development cycles, which may cause the revenue and operating income to fluctuate and fail to meet expectations.

It is not certain that we can successfully integrate Centra in a timely manner or at all or that any of the anticipated benefits will be realized. In addition, we cannot assure that there will not be substantial unanticipated costs associated with the integration process, that integration activities will not result in a decrease in revenues or a decrease in the value of our common stock, or that there will not be other material adverse effects from our integration efforts.

If we are unable to successfully integrate Centra, or if the benefits of the acquisition do not meet the expectations of financial or industry analysts, the market price of our common stock may decline.

Future acquisitions may result in disruptions to our business if we fail to adequately integrate acquired businesses.

We acquired Centra in January 2006 and THINQ in May 2005. As part of our overall business strategy, we expect to continue to acquire complementary businesses or technologies that will provide additional products or services offerings, additional industry expertise or an expanded geographic presence.

These acquisitions could result in the use of significant amounts of cash, the incurrence of debt or potentially dilutive issuances of equity securities which may reduce earnings per share. In addition, any acquisition may increase the risk of future write-offs for acquired in-process research and development, write-offs for the impairment of goodwill or long-lived assets or amortization of expenses related to intangible assets, any of which could materially adversely affect our business and our operating results. For example, as of August 31, 2006, our remaining goodwill balance was \$38.2 million. Acquisitions that we complete expose us to numerous risks, including:

Difficulties in the assimilation of the operations, technologies, products and personnel of the acquired company;

The diversion of management's attention from other business concerns;

Risks of entering markets in which we have no or limited prior experience;

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The potential loss of key employees, significant customers and strategic partners of the acquired company; and

Exposure to claims by terminated employees, stockholders of the acquired company or other third parties related to the acquisition. Although we generally obtain indemnification and other contractual protection against such claims, we cannot assure that they will be enforceable or sufficient to protect us.

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Delays in releasing new products or enhanced versions of our existing products could adversely affect our competitive position.

As part of our strategy, we expect to regularly release new products and new versions of our existing products. Even if our new products or new versions of our existing products contain the features and functionality our customers want, in the event we are unable to timely introduce these new products or product releases, our competitive position may be harmed. We cannot assure you that we will be able to successfully complete the development of currently planned or future products or product releases in a timely and efficient manner. Due to the complexity of our products, internal quality assurance testing and customer testing of pre-commercial releases may reveal product performance issues or desirable feature enhancements that could lead us to postpone the release of these products. In addition, the reallocation of resources associated with any postponement would likely cause delays in the development and release of other future products or enhancements to our currently available products. The reallocation of certain design, development and testing functions to our new lower-cost development center heightens risks relating to product design, development, testing and introduction. Any delay in releasing future products or enhancements of our products could harm our business.

If we release products containing defects, we may need to halt further shipments and our business and reputation would be harmed.

Products as complex as ours often contain unknown and undetected errors or performance problems. Although our products are subject to rigorous testing and quality control processes, serious defects are frequently found during the period immediately following introduction and initial shipment of new products or enhancements to existing products. Although we attempt to resolve all errors that we believe would be considered serious by our customers before shipment to them, our products are not error-free. These errors or performance problems could result in lost revenues or delays in customer acceptance and would be detrimental to our business and reputation. As is typical in the software industry, with each release we have discovered errors in our products after introduction. We will not be able to detect and correct all errors before releasing our products commercially and these undetected errors could be significant. We cannot assure you that undetected errors or performance problems in our existing or future products will not be discovered in the future or that known errors considered minor by us will not be considered serious by our customers, resulting in cancellation of orders, loss of customers, difficulties in achieving our sales goals, increased demands on our support services and a decrease in our revenues. To correct such errors, we may expend considerable time and resources to develop and release modifications to our software.

As a result of such errors, we may be subject to warranty and product liability claims that are costly or difficult to settle. Our products and services enable customers to manage critical business information. If product errors are alleged to cause or contribute to security and privacy breaches or misappropriation of confidential information, we may also be subject to significant liability. Although our license agreements contain provisions intended to limit our exposure to liability, we cannot assure that these limits will be adequate, that they will be enforceable or, if enforceable, that they will be interpreted favorably by a court.

Claims by third parties that we infringe their intellectual property rights may result in costly litigation.

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights, particularly in the software and Internet-related industries. We have in the past been and are presently subject to an intellectual property action. On August 19, 2003, EdiSync Systems, LLC filed a complaint against Centra in federal court in Denver, Colorado, alleging infringement of two patents for a remote multiple user editing system and method and seeking to enjoin us from continuing to sell our products, as well as unspecified compensatory damages. Although we believe that we have meritorious defenses and intend to vigorously defend this action, we can give no assurance that we will be able to achieve a satisfactory outcome. We could become subject to additional intellectual property infringement claims as the number of our competitors grows and our products and services overlap with competitive offerings. Any of these claims, even if not meritorious, could be expensive to defend and could divert management's attention from operating the company. If we become liable to third parties for infringing their intellectual property rights, we could be required to pay a substantial award of damages and to develop non-infringing technology, obtain a license or cease selling the products that contain the infringing intellectual property. We may be unable to develop non-infringing technology or obtain a license on commercially reasonable terms, if at all. In addition, agreements with our customers typically include indemnity provisions requiring us to hold these customers harmless against specified losses arising from third party claims that our products infringe the intellectual property rights of such other third parties. It is not possible to determine the maximum potential amount of liability under any indemnification obligations, whether or not asserted, due to the unique facts and circumstances that are likely to be involved in each particular claim.

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We may not be able to secure necessary funding in the future; additional funding may result in dilution to our stockholders.

We require substantial working capital to fund our business. Historically, we have had significant operating losses and negative cash flow from operations. We expect to use our available cash resources and credit facilities primarily to fund sales and marketing activities, research and development and continued operations, and possibly make future acquisitions. We believe that our existing capital resources will be sufficient to meet our capital requirements for the next twelve months. However, if our capital requirements increase materially from those currently planned or if revenues fail to materialize, we may require additional financing sooner than anticipated. If additional funds are raised through the issuance of equity securities, the percentage ownership of our stockholders will be reduced, stockholders may experience dilution or such equity securities may have rights, preferences or privileges senior to those of the holders of our common stock. Alternatively, or in addition to equity financing, we may incur additional debt to raise funds. Additional equity or debt financing may not be available when needed on terms favorable to us or at all. If adequate funds are not available or are not available on acceptable terms, we may be unable to develop or enhance our products and services, take advantage of future opportunities or respond to competitive pressures.

We may not be able to adequately protect our proprietary technology, and our competitors may be able to offer similar products and services that would harm our competitive position.

Our success depends upon our proprietary technology. We rely primarily on copyright, trademark and trade secret laws, confidentiality procedures and contractual provisions to establish and protect our proprietary rights. As part of our confidentiality procedures, we enter into non-disclosure agreements with our employees. Despite these precautions, third parties could copy or otherwise obtain and use our technology without authorization, which may represent potential sales and revenue losses that are difficult to quantify. Policing unauthorized use of our technology is difficult, time-consuming and costly. Were we to discover instances of unauthorized use, there can be no assurance that we would be able to enforce our proprietary rights or obtain adequate recovery for our losses. In addition, we have six patents issued in the United States and six patent applications pending in the United States. We cannot assure you that any patents will be issued for any of the pending patent applications. Even for the issued patents, or any patent issued to us in the future, there can be no assurance that such patent will protect our intellectual property, or will not be challenged by third parties. Furthermore, effective protection of intellectual property rights is unavailable or limited in certain foreign countries. We cannot assure you that the protection of our proprietary rights will be adequate or that our competitors will not independently develop similar technology, duplicate our products and services or design around any patents or other intellectual property rights we hold.

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

Our disaster recovery plan does not include fully redundant systems for our services at an alternate site. A disaster could severely harm our business because our services could be interrupted for an indeterminate length of time. Our operations depend upon our ability to maintain and protect the computer systems needed for the day-to-day operation of the Saba OnDemand business. A number of these computer systems are located on or near known earthquake fault zones. Although these systems are designed to be fault-tolerant, the systems are vulnerable to damage from fire, floods, earthquakes, power loss, telecommunications failures and other events. Additionally, we do not carry sufficient business insurance to compensate us for all potential losses that could occur.

We outsource the management and maintenance of our OnDemand business to third parties and will depend upon them to provide adequate management and maintenance services.

We rely on third parties to provide key components of our networks and systems. For instance, we rely on third-party Internet service providers to host our products for our OnDemand customers. We also rely on third-party communications service providers for the high-speed connections that link our and our Internet service providers' Web servers and office systems to the Internet. Our reliance on third party providers limits our ability to control

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critical customer service functions and communications systems. Any Internet or communications systems failure or interruption could result in disruption of our service or loss or compromise of customer orders and data. These failures, especially if they are prolonged or repeated, would make our services less attractive to customers and tarnish our reputation.

We depend upon continuing relationships with third-party integrators who support our solutions.

Our success depends upon the acceptance and successful integration by customers of our products. We often rely on third-party systems integrators to assist with implementation of our products. We must continue to rely on these systems integrators even as we increase the size of our professional services group. If large systems integrators fail to continue to support our solution or commit resources to us, if any of our customers are not able to successfully integrate our solution or if we are unable to adequately train our existing systems integration partners, our business, operating results and financial condition could suffer. Although we make reasonable efforts to ensure that our third party providers perform to our standards, we have only limited control over the level and quality of service provided by our current and future third-party integrators.

Our stock price may fluctuate substantially.

For example, from the beginning of fiscal 2005 through August 31, 2006, the market price for our common stock has fluctuated between \$7.14 per share and \$3.00 per share. The market price for our common stock may be affected by a number of factors, including those described above and the following:

The announcement of new products and services or product and service enhancements by us or our competitors;

Actual or anticipated quarterly variations in our results of operations or those of our competitors;

Changes in earnings estimates or recommendations by securities analysts that may follow our stock;

Developments in our industry, including announcements of significant acquisitions or strategic partnerships; and

General market conditions and other factors, including factors unrelated to our operating performance or the operating performance of our competitors.

In addition, the stock market in general, and the Nasdaq Global Market (formerly the Nasdaq National Market) technology companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of particular companies. Broad market and industry trends may also materially and adversely affect the market price of our common stock, regardless of our actual operating performance. Volatility in the market price and trading volume of our common stock may prevent our stockholders from selling their shares at a favorable price. In the past, following periods of volatility in the market price of a company's securities, securities class-action litigation has often been initiated against that company. Class-action litigation could result in substantial costs and a diversion of management's attention and resources.

The anti-takeover provisions in our charter documents could delay or prevent a change in control.

Our Amended and Restated Certificate of Incorporation and Amended and Restated Bylaws contain provisions that could make it harder for a third party to acquire us without the consent of our board of directors.

For example, if a potential acquiror were to make a hostile bid for us, the acquiror would not be able to call a special meeting of stockholders to remove our board of directors or act by written consent without a meeting. In addition, our board of directors has staggered terms that make it difficult to remove all directors at once. The acquiror would also be required to provide advance notice of its proposal to remove directors at an annual meeting. The acquiror will not be able to cumulate votes at a meeting, which will require the acquiror to hold more shares to gain representation on the board of directors than if cumulative voting were permitted.

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Our board of directors also has the ability to issue preferred stock that would significantly dilute the ownership of a hostile acquiror. In addition, Section 203 of the Delaware General Corporation Law limits business combination transactions with 15% stockholders that have not been approved by the board of directors. These provisions and other similar provisions make it more difficult for a third party to acquire us without negotiation.

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These provisions may apply even if the offer may be considered beneficial by some stockholders.

Our board of directors could choose not to negotiate with an acquiror that it did not feel was in our strategic interests. If the acquiror was discouraged from offering to acquire us or prevented from successfully completing a hostile acquisition by our anti-takeover measures, our stockholders could lose the opportunity to sell their shares at a favorable price.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

a. Exhibits

See Exhibit Index following the signature page.

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SIGNATURES

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

Dated: October 13, 2006

SABA SOFTWARE, INC.

By: /s/ BOBBY YAZDANI

Bobby Yazdani
*Chief Executive Officer and
Chairman of the Board
(Principal Executive Officer)*

By: /s/ PETER E WILLIAMS III

Peter E. Williams III
*Chief Financial Officer
(Principal Financial and Accounting Officer)*

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EXHIBIT INDEX

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 ⁽²⁾	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 ⁽³⁾	Amended and Restated Certificate of Incorporation of the Company effective as of April 12, 2000.
3.2 ⁽⁴⁾	Amendment to Amended and Restated Certificate of Incorporation of the Company effective as of May 12, 2003.
3.3 ⁽⁵⁾	Amendment to Amended and Restated Certificate of Incorporation of the Company effective as of November 19, 2004.
3.4 ⁽⁶⁾	Amended and Restated Bylaws of the Company effective as of August 24, 2006.
4.1	Reference is made to Exhibits 3.1, 3.2, 3.3 and 3.4.
10.1 ⁽⁷⁾	Summary of Non-Employee Director Compensation Policy.*
10.2 ⁽⁸⁾	CEO Compensation and Executive Officers Incentive Plan.*
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.
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.

- (1) Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the period ended February 28, 2005.
- (2) Incorporated by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K filed October 6, 2005.
- (3) Incorporated by reference to Exhibit 3.2 previously filed with the Company's Registration Statement on Form S-1/A (Registration No. 333-95761) filed on March 3, 2000.
- (4) Incorporated by reference to Exhibit 3.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended November 30, 2003.
- (5) Incorporated by reference to Exhibit 3.4 to the Company's Quarterly Report on Form 10-Q for the period ended November 30, 2004.
- (6) Incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed August 28, 2006.
- (7) Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed August 28, 2006.
- (8) Incorporated by reference to Exhibit 10.17 to the Company's Current Report on Form 8-K filed October 5, 2006.
- * Management contracts or compensatory plans or arrangements.