

ELOYALTY CORP  
Form 10-Q  
November 04, 2010  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**  
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 25, 2010

OR

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

Commission File Number 0-27975

**eLoyalty Corporation**

*(Exact Name of Registrant as Specified in Its Charter)*

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**Delaware**  
*(State or Other Jurisdiction of  
Incorporation or Organization)*

**36-4304577**  
*(I.R.S. Employer  
Identification No.)*

**150 Field Drive**  
**Suite 250**

**Lake Forest, Illinois 60045**

*(Address of Registrant's Principal Executive Offices) (Zip Code)*

**(847) 582-7000**

*(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 Section 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The number of shares of the registrant's Common Stock outstanding as of October 28, 2010 was 14,777,101.

**Table of Contents**

**TABLE OF CONTENTS**

|  | <b>Page</b> |
|--|-------------|
| <b>Part I. Financial Information</b>   |             |
| Item 1. <u>Financial Statements (unaudited)</u>  | 1           |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 17          |
| Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>                            | 34          |
| Item 4. <u>Controls and Procedures</u>   | 35          |
| <b>Part II. Other Information</b>  |             |
| Item 1. <u>Legal Proceedings</u>   | 35          |
| Item 1A. <u>Risk Factors</u>   | 35          |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>                           | 35          |
| Item 6. <u>Exhibits</u>  | 35          |
| <u>Signatures</u>  | 36          |

**Table of Contents****Part I. Financial Information****Item 1. Financial Statements****eLoyalty Corporation****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited and in thousands, except share and per share data)**

|  | September 25,<br>2010 | December 26,<br>2009 |
|--|-----------------------|----------------------|
| <b>ASSETS:</b>   |                       |                      |
| Current Assets:  |                       |                      |
| Cash and cash equivalents  | \$ 14,029             | \$ 28,982            |
| Restricted cash  | 3,745                 | 3,745                |
| Receivables (net of allowances of \$92 and \$151)  | 10,149                | 9,313                |
| Prepaid expenses   | 14,082                | 10,126               |
| Other current assets   | 2,166                 | 944                  |
| Total current assets   | 44,171                | 53,110               |
| Equipment and leasehold improvements, net  | 5,729                 | 6,194                |
| Goodwill   | 2,643                 | 2,643                |
| Intangibles, net   | 430                   | 476                  |
| Other long-term assets   | 11,452                | 8,180                |
| Total assets   | \$ 64,425             | \$ 70,603            |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY:</b>  |                       |                      |
| Current Liabilities:   |                       |                      |
| Accounts payable   | \$ 4,275              | \$ 3,634             |
| Accrued compensation and related costs   | 4,468                 | 5,762                |
| Unearned revenue   | 21,600                | 20,436               |
| Other current liabilities  | 4,456                 | 5,067                |
| Total current liabilities  | 34,799                | 34,899               |
| Long-term unearned revenue   | 13,043                | 9,526                |
| Other long-term liabilities  | 1,119                 | 1,705                |
| Total liabilities  | 48,961                | 46,130               |
| Redeemable Series B Stock, \$0.01 par value; 5,000,000 shares authorized and designated; 3,549,160 and 3,616,169 shares issued and outstanding at September 25, 2010 and December 26, 2009, respectively, with a liquidation preference of \$19,051 and \$19,733 at September 25, 2010 and December 26, 2009, respectively | 18,101                | 18,442               |
| Stockholders Equity:   |                       |                      |
| Preferred stock, \$0.01 par value; 35,000,000 shares authorized; none issued and outstanding   |                       |                      |
| Common stock, \$0.01 par value; 50,000,000 shares authorized; 15,592,431 and 14,871,521 shares issued at September 25, 2010 and December 26, 2009, respectively; and 14,769,819 and 14,220,279 outstanding at September 25, 2010 and December 26, 2009, respectively   | 156                   | 149                  |

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|   |           |           |
|---|-----------|-----------|
| Additional paid-in capital  | 207,494   | 203,627   |
| Accumulated deficit   | (202,377) | (190,821) |
| Treasury stock, at cost, 822,612 and 651,242 shares at September 25, 2010 and December 26, 2009, respectively | (4,251)   | (3,295)   |
| Accumulated other comprehensive loss  | (3,659)   | (3,629)   |
| Total stockholders' (deficit) equity  | (2,637)   | 6,031     |
| Total liabilities and stockholders' equity  | \$ 64,425 | \$ 70,603 |

See accompanying notes to the Condensed Consolidated Financial Statements.

**Table of Contents****eLoyalty Corporation****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited and in thousands, except per share data)**

|  | <b>For the</b>            |                  | <b>For the</b>           |                  |
|--|---------------------------|------------------|--------------------------|------------------|
|  | <b>Three Months Ended</b> | <b>Sept. 26,</b> | <b>Nine Months Ended</b> | <b>Sept. 26,</b> |
|  | <b>Sept. 25,</b>          | <b>2009</b>      | <b>Sept. 25,</b>         | <b>2009</b>      |
|  | <b>2010</b>               |                  | <b>2010</b>              | <b>2009</b>      |
| <b>Revenue:</b>  |                           |                  |                          |                  |
| Services   | \$ 18,085                 | \$ 19,688        | \$ 52,412                | \$ 59,764        |
| Product  | 4,188                     | 1,977            | 10,206                   | 14,847           |
| Revenue before reimbursed expenses (net revenue)                               | 22,273                    | 21,665           | 62,618                   | 74,611           |
| Reimbursed expenses  | 1,075                     | 1,033            | 2,667                    | 2,996            |
| Total revenue  | 23,348                    | 22,698           | 65,285                   | 77,607           |
| <b>Operating expenses:</b>   |                           |                  |                          |                  |
| Cost of services   | 10,608                    | 13,034           | 32,266                   | 39,614           |
| Cost of product  | 3,585                     | 1,353            | 8,516                    | 12,470           |
| Cost of revenue before reimbursed expenses                                     | 14,193                    | 14,387           | 40,782                   | 52,084           |
| Reimbursed expenses  | 1,075                     | 1,033            | 2,667                    | 2,996            |
| Total cost of revenue, exclusive of depreciation and amortization shown below: | 15,268                    | 15,420           | 43,449                   | 55,080           |
| Selling, general and administrative  | 9,670                     | 8,343            | 29,063                   | 26,022           |
| Severance and related costs  | 116                       | 276              | 936                      | 1,028            |
| Depreciation and amortization  | 984                       | 1,114            | 3,134                    | 3,373            |
| Total operating expenses   | 26,038                    | 25,153           | 76,582                   | 85,503           |
| Operating loss   | (2,690)                   | (2,455)          | (11,297)                 | (7,896)          |
| Interest and other (expense) income, net                                       | (47)                      | 287              | (65)                     | 93               |
| Loss from continuing operations before income taxes                            | (2,737)                   | (2,168)          | (11,362)                 | (7,803)          |
| Income tax (provision) benefit   | (15)                      | 18               | (58)                     | (16)             |
| Loss from continuing operations  | (2,752)                   | (2,150)          | (11,420)                 | (7,819)          |
| Loss on discontinued operations  |                           |                  | (136)                    |                  |
| Net loss   | (2,752)                   | (2,150)          | (11,556)                 | (7,819)          |
| Dividends related to Series B Stock  | (316)                     | (322)            | (956)                    | (969)            |
| Net loss available to common stockholders                                      | \$ (3,068)                | \$ (2,472)       | \$ (12,512)              | \$ (8,788)       |
| <b>Per common share:</b>   |                           |                  |                          |                  |
| Basic loss from continuing operations  | \$ (0.20)                 | \$ (0.16)        | \$ (0.84)                | \$ (0.59)        |

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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Basic loss from discontinued operations   | \$        | \$        | \$ (0.01) | \$        |
| Basic net loss available to common stockholders   | \$ (0.22) | \$ (0.19) | \$ (0.92) | \$ (0.66) |
| Per common share:   |           |           |           |           |
| Diluted loss from continuing operations   | \$ (0.20) | \$ (0.16) | \$ (0.84) | \$ (0.59) |
| Diluted loss from discontinued operations   | \$        | \$        | \$ (0.01) | \$        |
| Diluted net loss available to common stockholders   | \$ (0.22) | \$ (0.19) | \$ (0.92) | \$ (0.66) |
| Shares used to calculate basic net loss per share   | 13,784    | 13,317    | 13,644    | 13,218    |
| Shares used to calculate diluted net loss per share   | 13,784    | 13,317    | 13,644    | 13,218    |
| Stock-based compensation, primarily restricted stock, is included in individual line items above: |           |           |           |           |
| Cost of services  | \$ 23     | \$ 34     | \$ 95     | \$ 419    |
| Selling, general and administrative   | 1,469     | 1,222     | 4,338     | 4,262     |
| Severance and related costs   |           |           | 76        | 248       |

See accompanying notes to the Condensed Consolidated Financial Statements.

**Table of Contents****eLoyalty Corporation****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited and in thousands)**

|   | <b>For the<br/>Nine Months Ended</b> |                           |
|---|--------------------------------------|---------------------------|
|   | <b>Sept. 25,<br/>2010</b>            | <b>Sept. 26,<br/>2009</b> |
| <b>Cash Flows from Operating Activities:</b>  |                                      |                           |
| Net loss  | \$ (11,556)                          | \$ (7,819)                |
| Adjustments to reconcile net loss to net cash (used in) provided by operating activities: |                                      |                           |
| Depreciation and amortization   | 3,134                                | 3,373                     |
| Stock-based compensation  | 4,433                                | 4,681                     |
| Loss on discontinued operations   | 136                                  |                           |
| (Reversal) provision for uncollectible amounts  | (79)                                 | 10                        |
| Severance and related costs   | 89                                   | 248                       |
| Changes in assets and liabilities:  |                                      |                           |
| Receivables   | (779)                                | (1,339)                   |
| Prepaid expenses  | (7,396)                              | (8,323)                   |
| Other assets  | (1,220)                              | (1,456)                   |
| Accounts payable  | 650                                  | (270)                     |
| Accrued compensation and related costs  | (1,292)                              | 957                       |
| Unearned revenue  | 4,695                                | 17,678                    |
| Other liabilities   | 31                                   | (502)                     |
| <b>Net cash (used in) provided by operating activities</b>                                | <b>(9,154)</b>                       | <b>7,238</b>              |
| <b>Cash Flows from Investing Activities:</b>  |                                      |                           |
| Capital expenditures and other  | (2,425)                              | (2,987)                   |
| Sale of short-term investments  |                                      | 337                       |
| <b>Net cash used in investing activities</b>  | <b>(2,425)</b>                       | <b>(2,650)</b>            |
| <b>Cash Flows from Financing Activities:</b>  |                                      |                           |
| Payment of Series B Stock dividends   | (1,297)                              | (648)                     |
| Principal payments under capital lease obligations  | (1,238)                              | (994)                     |
| Acquisition of treasury stock   | (956)                                | (715)                     |
| Increase in restricted cash   |                                      | (91)                      |
| Proceeds from stock compensation and employee stock purchase plans, net                   | 133                                  | 112                       |
| <b>Net cash used in financing activities</b>  | <b>(3,358)</b>                       | <b>(2,336)</b>            |
| <b>Effect of exchange rate changes on cash and cash equivalents</b>                       | <b>(16)</b>                          | <b>81</b>                 |
| (Decrease) increase in cash and cash equivalents  | (14,953)                             | 2,333                     |
| Cash and cash equivalents, beginning of period  | 28,982                               | 27,064                    |
| <b>Cash and cash equivalents, end of period</b>   | <b>\$ 14,029</b>                     | <b>\$ 29,397</b>          |



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### Non-Cash Investing and Financing Transactions:

|  |        |        |
|--|--------|--------|
| Capital lease obligations incurred     | \$ 215 | \$ 865 |
| Capital equipment purchased on credit  | 215    | 865    |
| Change in net unrealized security loss |        | (108)  |

### Supplemental Disclosures of Cash Flow Information:

|               |          |          |
|---------------|----------|----------|
| Interest paid | \$ (125) | \$ (293) |
|---------------|----------|----------|

See accompanying notes to the Condensed Consolidated Financial Statements.

**Table of Contents**

**eLoyalty Corporation**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note One General**

In the opinion of management, the accompanying unaudited condensed consolidated financial statements of eLoyalty Corporation ( we, eLoyalty, or the Company ) include all normal and recurring adjustments necessary for a fair presentation of our condensed consolidated financial position as of September 25, 2010 and December 26, 2009, the condensed consolidated results of our operations for the three months and nine months ended September 25, 2010 and September 26, 2009, and our condensed consolidated cash flows for the nine months ended September 25, 2010 and September 26, 2009, and are in accordance with United States generally accepted accounting principles ( GAAP ) and in conformity with Securities and Exchange Commission ( SEC ) Rule 10-01 of Regulation S-X.

The results of operations for any interim period are not necessarily indicative of the results for the full year. The accompanying financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto in our Annual Report on Form 10-K for the fiscal year ended December 26, 2009.

**Note Two Summary of Significant Accounting Policies**

Certain data center expenses that have been previously reported as Selling, general and administrative have been reclassified as Cost of services within our Behavioral Analytics Service Business Unit. We believe this revised classification will provide a clearer understanding of our key profit/loss drivers. As a result, we reclassified \$0.5 million and \$1.6 million for the three months and nine months ended September 26, 2009, respectively, from Selling, general and administrative to Cost of services. This change did not have an impact on net loss.

**Note Three Revenue Recognition**

*Behavioral Analytics Service Business Unit*

**Behavioral Analytics Service Line**

Managed services revenue included in the Behavioral Analytics Service Line consists of planning, deployment, training, and subscription fees. Planning, deployment, and training fees, which are considered to be installation fees related to long-term subscription contracts, are deferred until an installation is complete and are then recognized over the term of the applicable subscription contract. The terms of these subscription contracts generally range from three to five years. Installation costs incurred are deferred up to an amount not to exceed the amount of deferred installation revenue and additional amounts that are recoverable based on the contractual arrangement. These costs are included in Prepaid expenses and Other long-term assets. Such costs are amortized over the term of the subscription contract. Costs in excess of the foregoing revenue amount are expensed in the period incurred.

The amount of revenue generated from Behavioral Analytics Service subscription fees is based on a number of factors, such as the number of agents accessing the Behavioral Analytics System and/or the number of hours of calls analyzed during the relevant month of the term of the subscription contract. This revenue is recognized as the service is performed for the client.

Consulting services revenue included in the Behavioral Analytics Service Line primarily consists of fees charged to our clients to provide post-deployment follow-on consulting services, which generally consist of custom data analysis, the implementation of enhancements, and training. These follow-on consulting services are generally performed for our clients on a fixed-fee basis. Revenue is recognized as the services are performed, with performance generally assessed on the ratio of actual hours incurred to date compared to the total estimated hours over the entire term of the contract.

**Marketing Managed Services Line**

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Marketing Managed Services revenue is derived from marketing application hosting and email fulfillment. Revenue related to hosting services is generally in the form of fixed monthly fees received from our clients and is recognized as the services are performed for each client. Any related setup fee would be recognized over the contract period of the hosting arrangement. Revenue related to email fulfillment services is recognized as the services are provided to the client, based on the number of emails distributed for the client.

## **Table of Contents**

### ***Integrated Contact Solutions Business Unit***

#### **Integrated Contact Solutions Service Line**

Managed services revenue included in the Integrated Contact Solutions Service Line consists of fees generated from our contact center support and monitoring services. Support and monitoring services are generally contracted for a fixed fee, and the revenue is recognized ratably over the term of the contract. Support fees that are contracted on a time-and-materials basis are recognized as the services are performed for the client.

For fixed fee Managed services contracts, where the Company provides support for third-party software and hardware, revenue is recorded at the gross amount of the sale. If the contract does not meet the requirements for gross reporting, then Managed services revenue is recorded at the net amount of the sale.

Consulting services revenue included in the Integrated Contact Solutions Service Line consists of the modeling, planning, configuring, or integrating of an Internet Protocol ( IP ) network solution within our clients' contact center environments. These services are provided to the client on a time-and-materials or fixed-fee basis. For the integration of a system, the Company recognizes revenue as the services are performed, with performance generally assessed on the ratio of hours incurred to date compared to the total estimated hours over the entire term of the contract. For all other consulting services, we recognize revenue as the services are performed for the client.

Revenue from the sale of Product, which is generated primarily from the resale of third-party software and hardware by the Company, is generally recorded at the gross amount of the sale.

Within the Integrated Contact Solutions Service Line, Consulting services, Managed services, and the resale of Product may be sold and delivered together. In arrangements that include the resale of software, vendor-specific objective evidence ( VSOE ) must be determined for each of the individual elements. If VSOE does not exist for the allocation of revenue to the various elements of the arrangement, then all revenue from the arrangement is deferred until all elements of the arrangement without VSOE have been delivered to the client. If the remaining undelivered elements are post-contract support ( PCS ) or other deliverables with similar attribution periods, then the arrangement revenue is recognized ratably over the remaining service period.

#### **Traditional CRM Service Line**

Consulting services revenue included in the Company's traditional CRM Service Line consists of fees generated from our operational consulting and systems integration services or from building systems for our clients. These services are provided to our clients on a time-and-materials or fixed-fee basis. For the integration or building of a system, the Company recognizes revenue as the services are performed, with performance generally assessed on the ratio of hours incurred to date compared to the total estimated hours over the entire term of the contract. For all other consulting services, we recognize revenue as the services are performed for the client.

Managed services revenue included in the traditional CRM Service Line consists of fees generated from our remote application support. Contracts for remote application support can be based on a fixed-fee or time-and-materials basis. For fixed-fee support, revenue is recognized ratably over the contract period. For time-and-material contracts, revenue is recognized as the services are provided to the client.

Multiple-element arrangements are segmented into separate earning processes when the elements have objective and reliable evidence of fair value and have value to the customer on a stand-alone basis. Revenue related to contracts with multiple elements is allocated based on the fair value of the element and is recognized in accordance with our revenue recognition policy for each type of element, as described above. If the fair value for any undelivered element cannot be established, then revenue is deferred until all elements have been delivered to the client. If PCS or similar services are the only remaining activity without established fair value, then the revenue for the entire arrangement is recognized ratably over the service period.

Reimbursed expenses revenue includes billable costs related to travel and other out-of-pocket expenses incurred while performing services for our clients. The cost of third-party product and support may be included within this category if the transaction does not satisfy the requirements for gross reporting. An equivalent amount of reimbursable expenses is included in Cost of revenue.



**Table of Contents**

Payments received for Managed services contracts in excess of the amount of revenue recognized for these contracts are recorded as unearned revenue until revenue recognition criteria are met.

**Note Four Stock-Based Compensation**

Stock-based compensation expense was \$1.5 million and \$1.3 million for the three months ended September 25, 2010 and September 26, 2009, respectively, and \$4.5 million and \$4.9 million for the nine months ended September 25, 2010 and September 26, 2009, respectively. The Company recognizes stock-based compensation expense on a straight-line basis over the vesting period. The Company has established its forfeiture rate based on historical experience.

As of September 25, 2010, there were a total of 1,076,466 shares of Common Stock available for future grants under the 1999 Plan, the 2000 Plan, and from treasury stock.

**Restricted Stock**

Restricted and installment stock award activity was as follows for the nine months ended September 25, 2010:

|   | Shares    | Weighted<br>Average<br>Price |
|---|-----------|------------------------------|
| Nonvested balance at December 26, 2009  | 985,208   | \$ 7.14                      |
| Granted                                 | 530,100   | \$ 5.96                      |
| Vested                                  | (518,653) | \$ 7.37                      |
| Forfeited                               | (25,852)  | \$ 11.30                     |
| Nonvested balance at September 25, 2010 | 970,803   | \$ 6.26                      |

| (In millions)  | For the<br>Three Months Ended |                   | For the<br>Nine Months Ended |                   |
|--|-------------------------------|-------------------|------------------------------|-------------------|
|  | Sept. 25,<br>2010             | Sept. 26,<br>2009 | Sept. 25,<br>2010            | Sept. 26,<br>2009 |
| Total fair value of restricted and installment stock awards vested | \$ 0.7                        | \$ 0.6            | \$ 2.9                       | \$ 2.3            |

As of September 25, 2010, there remained \$5.0 million of unrecognized compensation expense related to restricted and installment stock awards. These costs are expected to be recognized over a weighted average period of 1.5 years.

**Stock Options**

The Company recognized compensation expense related to option awards of \$0.3 million for both the three months ended September 25, 2010 and the three months ended September 26, 2009, and \$0.9 million for both the nine months ended September 25, 2010 and the nine months ended September 26, 2009.

**Table of Contents**

Option activity was as follows for the nine months ended September 25, 2010:

|   | <b>Options</b> | <b>Weighted<br/>Average<br/>Exercise Price</b> |
|---|----------------|--|
| Outstanding as of December 26, 2009                             | 1,231,205      | \$ 13.57                                       |
| Granted   | 30,000         | \$ 6.34  |
| Exercised   | (895)          | \$ 2.73  |
| Forfeited   | (7,098)        | \$ 194.05                                      |
| Outstanding as of September 25, 2010                            | 1,253,212      | \$ 12.39                                       |
| Exercisable as of September 25, 2010                            | 926,173        | \$ 14.23                                       |
| Outstanding intrinsic value at September 25, 2010 (in millions) | \$ 1.3         |  |
| Exercisable intrinsic value at September 25, 2010 (in millions) | \$ 0.9         |  |

| <b>(In millions)</b>                       | <b>For the<br/>Three Months Ended</b> |                           | <b>For the<br/>Nine Months Ended</b> |                           |
|--|---------------------------------------|---------------------------|--------------------------------------|---------------------------|
|  | <b>Sept. 25,<br/>2010</b>             | <b>Sept. 26,<br/>2009</b> | <b>Sept. 25,<br/>2010</b>            | <b>Sept. 26,<br/>2009</b> |
| Total fair value of stock options vested   | \$ 0.3                                | \$ 0.3                    | \$ 0.9                               | \$ 1.1                    |
| Intrinsic value of stock options exercised |                                       |                           |                                      |                           |
| Proceeds received from option exercises    |                                       |                           |                                      |                           |

As of September 25, 2010, there remains \$1.2 million of unrecognized compensation expense related to stock options. These costs are expected to be recognized over a weighted average period of 1.4 years.

The fair value for options granted during the nine months ended September 25, 2010 and September 26, 2009, was estimated on the date of grant using a Black-Scholes option-pricing model. The Company used the following assumptions:

|                          | <b>For the Nine Months Ended</b> |                           |     |
|--------------------------|----------------------------------|---------------------------|-----|
|                          | <b>Sept. 25,<br/>2010</b>        | <b>Sept. 26,<br/>2009</b> |     |
| Risk-free interest rates | 1.8%                             | 1.8%                      |     |
| Expected dividend yield  |                                  |                           |     |
| Expected volatility      | 68%                              | 66%                       | 69% |
| Expected lives           | 6 years                          | 6 years                   |     |

Historical Company information is the primary basis for the selection of expected life, expected volatility, and expected dividend yield assumptions. The risk-free interest rate is selected based on the yields from U.S. Treasury Strips with a remaining term equal to the expected term of the options being valued.

**Other Stock Compensation****ICS Performance Unit Awards**

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On November 3, 2009, the Compensation Committee approved the grant of 65,000 performance unit awards to certain employees of the Integrated Contact Solutions Business Unit and on May 5, 2010, the Compensation Committee approved the grant of an additional 22,000 performance unit awards. The performance period for the awards began on October 1, 2009 and ends on December 29, 2012. On the last day of the performance period, the performance units granted will become fully vested. The amount earned, if any, for each vested performance unit will vary based on (1) the ultimate value of the Integrated Contact Solutions Business Unit relative to the baseline value and (2) the number of participants receiving performance units (because a fraction of the total increase in Integrated Contact Solutions Business Unit value will fund an incentive pool that is divided among all participants based on the relative number of the performance units held by each participant at the end of the performance period). The distribution of this pool will be settled in shares of eLoyalty Common Stock; the number of shares issued will be determined based on the ultimate value of the incentive pool, divided by the 10-day average share price of eLoyalty Common Stock as of the distribution date.



**Table of Contents**

For the three months and nine months ended September 25, 2010, the Company expensed \$0.2 million and \$0.6 million for this program, respectively. The cost of this program is being expensed over a thirty-two month period. As of September 25, 2010, there remains \$1.6 million of unrecognized compensation expense related to the ICS performance units. These costs are expected to be recognized over a weighted average period of 1.3 years. There are an estimated 380,170 shares of eLoyalty Common Stock potentially issuable with this program as of September 25, 2010.

**Employee Stock Purchase Plan**

The Employee Stock Purchase Plan is intended to qualify as an employee stock purchase plan under section 423 of the Internal Revenue Code. Eligible employees are permitted to purchase shares of Common Stock at below-market prices. Under this Plan, the purchase period opens on the first day of the calendar quarter and ends on the last business day of each calendar quarter. A total of 10,055 shares and 11,158 shares were issued during the three months ended September 25, 2010 and September 26, 2009, respectively, and 26,020 shares and 38,370 shares were issued during the nine months ended September 25, 2010 and September 26, 2009, respectively. We recorded \$16 thousand and \$23 thousand of expense for this plan for the three months ended September 25, 2010 and September 26, 2009, respectively, and \$45 thousand and \$67 thousand of expense for the nine months ended September 25, 2010 and September 26, 2009, respectively.

**Note Five Severance and Related Costs**

Severance costs are comprised primarily of contractual salary and related fringe benefits over the severance payment period. Facility costs include losses on contractual lease commitments, net of estimated sublease recoveries, and impairment of leasehold improvements and certain office assets.

For the third quarter of 2010, the Company recorded \$0.1 million of expense related to severance and related costs for the elimination of eight positions. In the third quarter of 2009, the Company recorded \$0.3 million of expense related to severance and related costs for the elimination of seven positions. For the first nine months of 2010, the Company recorded \$0.9 million of expense related to severance and related costs for the elimination of fifty-five positions. In the first nine months of 2009, the Company recorded \$1.0 million of expense related to severance and related costs for the elimination of twenty-six positions and an adjustment to sublease recoveries.

For the nine months ended September 25, 2010, the Company made cash payments of \$0.9 million related to cost-reduction actions. For the nine months ended September 26, 2009, the Company made cash payments of \$1.2 million related to cost-reduction actions. The cash payments in the first nine months of 2010 and 2009 were primarily related to severance and related costs, office space reductions, and office closures.

The severance and related costs and their utilization for the nine months ended September 25, 2010 and September 26, 2009 were as follows:

| (In millions)                                      | Employee<br>Severance | Facilities | Total  |
|--|-----------------------|------------|--------|
| <b>Balance, December 26, 2009</b>                  | \$                    | \$ 0.3     | \$ 0.3 |
| Charges  | 0.9                   |            | 0.9    |
| Adjustments charged to severance and related costs |                       |            |        |
| Charged to severance and related costs             | 0.9                   |            | 0.9    |
| Payments   | (0.8)                 | (0.1)      | (0.9)  |
| <b>Balance, September 25, 2010</b>                 | \$ 0.1                | \$ 0.2     | \$ 0.3 |

**Table of Contents**

| (In millions)                                      | Employee<br>Severance | Facilities | Total  |
|--|-----------------------|------------|--------|
| <b>Balance, December 27, 2008</b>                  | \$ 0.1                | \$ 0.4     | \$ 0.5 |
| Charges  | 1.0                   |            | 1.0    |
| Adjustments charged to severance and related costs |                       |            |        |
| Charged to severance and related costs             | 1.0                   |            | 1.0    |
| Payments   | (1.1)                 | (0.1)      | (1.2)  |
| <b>Balance, September 26, 2009</b>                 | \$                    | \$ 0.3     | \$ 0.3 |

As of September 25, 2010, the \$0.3 million that remained reserved relates to severance payments and facility lease payments, net of estimated sublease recoveries, and these lease payments will be paid pursuant to contractual lease terms through February 2015. The \$0.3 million balance is apportioned among Accrued Compensation and Related Costs, Other current liabilities, and Other long-term liabilities. As of September 26, 2009, the \$0.3 million that remained reserved relates to facility lease payments, net of estimated sublease recoveries, and these lease payments will be paid pursuant to contractual lease terms through February 2015. The \$0.3 million balance is apportioned between Other current liabilities and Other long-term liabilities.

**Note Six Current Prepaid Expenses**

Current prepaid expenses were \$14.1 million and \$10.1 million as of September 25, 2010 and December 26, 2009, respectively. Current prepaid expenses primarily consist of third-party support costs related to our Integrated Contact Solutions Managed services and deferred costs related to the Behavioral Analytics Service. These costs are recognized over the contract terms of the respective agreements, generally one to five years. Costs included in current prepaid expenses will be recognized within the next twelve months. Current prepaid expenses consisted of the following:

| (In millions)  | September 25,<br>2010 | As of<br>December 26,<br>2009 |
|--|-----------------------|-------------------------------|
| Integrated Contact Solutions prepaid third-party support costs | \$ 8.8                | \$ 4.7                        |
| Behavioral Analytics Service deferred costs                    | 2.0                   | 2.6                           |
| Other  | 3.3                   | 2.8                           |
| Total  | \$ 14.1               | \$ 10.1                       |

**Note Seven Intangible Assets, net**

Net intangible assets were \$0.4 million as of September 25, 2010 and \$0.5 million as of December 26, 2009. Intangible assets reflect costs related to patent and trademark applications, Marketing Managed Services customer relationships acquired in 2004, and the 2003 purchase of a license for certain intellectual property. Patent and trademark applications are amortized over 120 months. The other intangible assets are fully amortized. Amortization expense of intangible assets for the nine months ended September 25, 2010 was \$0.1 million and will be \$0.1 million annually thereafter.

| (In millions)                                 | September 25,<br>2010 | As of<br>December 26,<br>2009 |
|---|-----------------------|-------------------------------|
| Gross intangible assets                       | \$ 2.8                | \$ 2.8                        |
| Accumulated amortization of intangible assets | (2.4)                 | (2.3)                         |

|       |        |        |
|-------|--------|--------|
| Total | \$ 0.4 | \$ 0.5 |
|-------|--------|--------|

**Table of Contents****Note Eight Other Long-Term Assets**

Other long-term assets were \$11.5 million as of September 25, 2010 and \$8.2 million as of December 26, 2009. Other long-term assets primarily consist of third-party support costs related to our Integrated Contact Solutions Managed services and deferred costs related to the Behavioral Analytics Service. These costs are recognized over the terms of the respective agreements, generally one to five years. Costs included in long-term assets will be recognized over the remaining term of the agreements beyond the first twelve months. Other long-term assets consisted of the following:

| (In millions)  | September 25,<br>2010 | As of<br>December 26,<br>2009 |
|--|-----------------------|-------------------------------|
| Integrated Contact Solutions prepaid third-party support costs | \$ 7.8                | \$ 4.1                        |
| Behavioral Analytics Service deferred costs                    | 3.5                   | 2.5                           |
| Other  | 0.2                   | 1.6                           |
| Total  | \$ 11.5               | \$ 8.2                        |

**Note Nine Current Unearned Revenue**

Current unearned revenue was \$21.6 million as of September 25, 2010 and \$20.4 million as of December 26, 2009. Current unearned revenue reflects prepayment by our clients in advance of our recognition of this revenue. Payments are generally received in advance from clients that are utilizing our Behavioral Analytics Service and Integrated Contact Solutions Managed services. Current unearned revenue will be recognized within the next twelve months and consisted of the following:

| (In millions)                                 | September 25,<br>2010 | As of<br>December 26,<br>2009 |
|---|-----------------------|-------------------------------|
| Integrated Contact Solutions Managed Services | \$ 14.4               | \$ 9.8                        |
| Behavioral Analytics Service Managed Services | 7.0                   | 10.4                          |
| Other   | 0.2                   | 0.2                           |
| Total   | \$ 21.6               | \$ 20.4                       |

**Note Ten Long-Term Unearned Revenue**

Long-term unearned revenue was \$13.0 million and \$9.5 million as of September 25, 2010 and December 26, 2009, respectively. Long-term unearned revenue reflects prepayment by our clients in advance of our recognition of this revenue. Payments are generally received in advance from clients that are utilizing our Behavioral Analytics Service and Integrated Contact Solutions Managed services. Long-term unearned revenue reflects revenue that will be recognized beyond the next twelve months and consisted of the following:

| (In millions)                                 | September 25,<br>2010 | As of<br>December 26,<br>2009 |
|---|-----------------------|-------------------------------|
| Integrated Contact Solutions Managed Services | \$ 9.8                | \$ 5.7                        |
| Behavioral Analytics Service Managed Services | 3.2                   | 3.8                           |
| Total   | \$ 13.0               | \$ 9.5                        |



**Table of Contents****Note Eleven Comprehensive Net Loss**

Comprehensive net loss is comprised of the following:

| (In millions)                            | For the<br>Three Months Ended |                   | For the<br>Nine Months Ended |                   |
|--|-------------------------------|-------------------|------------------------------|-------------------|
|  | Sept. 25,<br>2010             | Sept. 26,<br>2009 | Sept. 25,<br>2010            | Sept. 26,<br>2009 |
| Net loss                                 | \$ (2.8)                      | \$ (2.2)          | \$ (11.6)                    | \$ (7.8)          |
| Other comprehensive loss:                |                               |                   |                              |                   |
| Unrealized loss on marketable securities |                               | (0.3)             |                              | (0.1)             |
| Effect of currency translation           | 0.1                           | 0.1               |                              | 0.1               |
| Comprehensive net loss                   | \$ (2.7)                      | \$ (2.4)          | \$ (11.6)                    | \$ (7.8)          |

The accumulated other comprehensive loss, which represents the cumulative effect of foreign currency translation adjustments, was \$3.7 million and \$3.6 million at September 25, 2010 and December 26, 2009, respectively. In the third quarter of 2009, the unrealized loss on marketable securities related to stock of a publicly-traded company, which was classified as available-for-sale and the fair value was included in Other current assets. During the three months ended September 26, 2009, the Company sold these equity securities for \$0.3 million.

**Note Twelve Loss Per Share**

The following table sets forth the computation of the loss and shares used in the calculation of basic and diluted loss per share:

| (In millions)  | For the<br>Three Months Ended |                   | For the<br>Nine Months Ended |                   |
|--|-------------------------------|-------------------|------------------------------|-------------------|
|  | Sept. 25,<br>2010             | Sept. 26,<br>2009 | Sept. 25,<br>2010            | Sept. 26,<br>2009 |
| Net loss   | \$ (2.8)                      | \$ (2.2)          | \$ (11.6)                    | \$ (7.8)          |
| Series B Stock dividends <sup>(1)</sup>                        | (0.3)                         | (0.3)             | (0.9)                        | (1.0)             |
| Net loss available to common stockholders                      | \$ (3.1)                      | \$ (2.5)          | \$ (12.5)                    | \$ (8.8)          |
| Per common share   |                               |                   |                              |                   |
| Basic net loss before Series B Stock dividends                 | \$ (0.20)                     | \$ (0.17)         | \$ (0.85)                    | \$ (0.59)         |
| Basic net loss available to common stockholders                | \$ (0.22)                     | \$ (0.19)         | \$ (0.92)                    | \$ (0.66)         |
| (In thousands)   |                               |                   |                              |                   |
| Weighted average common shares outstanding                     | 13,784                        | 13,317            | 13,644                       | 13,218            |
| Currently antidilutive common stock equivalents <sup>(2)</sup> | 3,741                         | 4,277             | 3,986                        | 4,129             |

(1) During the second quarter of 2010, the Company's Board of Directors declared a cash dividend of \$0.1785 per share on the 7% Series B convertible preferred stock (Series B Stock) payable July 1, 2010.

- (2) In periods in which there was a loss, the dilutive effect of common stock equivalents, which is primarily related to the Series B Stock, was not included in the diluted loss per share calculation as it was antidilutive.

**Note Thirteen Leases**

***Capital Leases***

The Company acquired \$0.2 million and \$0.9 million of computer equipment using capital leases in the first nine months of 2010 and in fiscal year 2009, respectively. These assets were related primarily to investments in our Behavioral Analytics™ Service Line. In 2009 and prior years, the Company was required to issue an irrevocable letter of credit for a portion of the lease amount as additional consideration for the duration of the executed lease agreement. In 2010, newly executed leases do not require an irrevocable letter of credit. There was \$0.4 million of depreciation on capital leases in the third quarter of 2010 and in the third quarter of 2009, and \$1.2 million and \$1.0 million of depreciation on capital leases in the first nine months of 2010 and 2009, respectively. All capital leases are for terms of either thirty or thirty-six months. The liabilities for these capital leases are included in Other current liabilities and Other long-term liabilities on the balance sheet. We expect capital lease investments to increase between \$1.5 million to \$2.0 million for fiscal year 2010.

**Table of Contents**

The following is a schedule, by year, of future minimum lease payments under capital leases, together with the present value of the net minimum lease payments as of September 25, 2010:

| (In Millions)                                  | Amount        |
|--|---------------|
| Year   |               |
| 2010   | \$ 0.5        |
| 2011   | 1.1           |
| 2012   | 0.3           |
| 2013   |               |
| 2014   |               |
| Thereafter                                     |               |
| <b>Total minimum lease payments</b>            | <b>\$ 1.9</b> |
| Less: estimated executory costs                | (0.2)         |
| <b>Net minimum lease payments</b>              | <b>\$ 1.7</b> |
| Less: amount representing interest             | (0.1)         |
| <b>Present value of minimum lease payments</b> | <b>\$ 1.6</b> |

**Note Fourteen Segment Information**

The Company operates in two business segments, the Behavioral Analytics Service Business Unit and the Integrated Contact Solutions Business Unit. These segments are consistent with the Company's management of the business and reflect its internal financial reporting structure and operating focus.

The Behavioral Analytics Service Business Unit focuses on solutions that improve the reliability of call recording and applies human behavioral modeling to analyze and improve customer interactions. The Behavioral Analytics Service is primarily a managed hosted solution and is delivered as a subscription service. Revenue from follow-on consulting services, deployments, and subscription services, as well as marketing application hosting and email fulfillment services, are included in this Business Unit.

The Integrated Contact Solutions Business Unit focuses on helping clients realize the benefits of transitioning their contact centers to a single network infrastructure from the traditional two-network (voice network and separate data network) model. Revenue from Consulting services, Managed services, Product resale, traditional CRM, and remote application support services are included in this Business Unit.

Management believes that Segment Operating Income/(Loss) Before Stock-Based Compensation, Severance and Related Costs, and Depreciation and Amortization is an appropriate measure of evaluating the operational performance of the Company's segments. However, this measure should be considered in addition to, not as a substitute for, or superior to, income from operations or other measures of financial performance prepared in accordance with GAAP. The Company does not allocate severance and related costs, depreciation and amortization or other items below the Operating Income/(Loss) level to its business segments. Also, the Company does not track or review asset information, other than capital investments, by reportable segments.



**Table of Contents**

The following table presents summarized information by business segment along with a reconciliation to operating loss:

| (In millions)  | Segment Reporting<br>Three Months Ended September 25, 2010 |  |           |          |
|--|--|--|-----------|----------|
|  | Behavioral<br>Analytics<br>Service<br>Business<br>Unit     | Integrated<br>Contact<br>Solutions<br>Business<br>Unit | Corporate | Total    |
| Revenue  |  |  |           |          |
| Services   | \$ 6.8   | \$ 11.3  | \$        | \$ 18.1  |
| Product  |  | 4.2  |           | 4.2      |
| Net revenue  | 6.8  | 15.5   |           | 22.3     |
| Reimbursed expenses  | 0.1  | 0.9  |           | 1.0      |
| Total revenue  | 6.9  | 16.4   |           | 23.3     |
| Segment operating (loss)/income before stock-based compensation, severance and related costs and depreciation and amortization | (0.6)  | 2.9  | (2.4)     | (0.1)    |
| Stock-based compensation   | 0.9  | 0.4  | 0.2       | 1.5      |
| Severance and related costs  |  |  | 0.1       | 0.1      |
| Depreciation and amortization  |  |  | 1.0       | 1.0      |
| Operating (loss)/income  | (1.5)  | 2.5  | (3.7)     | (2.7)    |
| Interest and other (expense)/income  |  |  | (0.1)     | (0.1)    |
| Income taxes   |  |  |           |          |
| Loss on discontinued operations  |  |  |           |          |
| Net (loss)/income  | \$ (1.5)   | \$ 2.5   | \$ (3.8)  | \$ (2.8) |
| Capital investments  | \$ 0.2   | \$ 0.3   | \$ 0.1    | \$ 0.6   |

| (In millions)  | Segment Reporting<br>Three Months Ended September 26, 2009 |  |           |         |
|--|--|--|-----------|---------|
|  | Behavioral<br>Analytics<br>Service<br>Business<br>Unit     | Integrated<br>Contact<br>Solutions<br>Business<br>Unit | Corporate | Total   |
| Revenue  |  |  |           |         |
| Services   | \$ 5.4   | \$ 14.3  | \$        | \$ 19.7 |
| Product  |  | 2.0  |           | 2.0     |
| Net revenue  | 5.4  | 16.3   |           | 21.7    |
| Reimbursed expenses  |  | 1.0  |           | 1.0     |
| Total revenue  | 5.4  | 17.3   |           | 22.7    |
| Segment operating (loss)/income before stock-based compensation, severance and related costs and depreciation and amortization | (1.1)  | 3.4  | (2.1)     | 0.2     |
| Stock-based compensation   | 0.7  | 0.3  | 0.3       | 1.3     |
| Severance and related costs  |  |  | 0.3       | 0.3     |

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|                                     |          |        |          |          |
|-------------------------------------|----------|--------|----------|----------|
| Depreciation and amortization       |          |        | 1.1      | 1.1      |
| Operating (loss)/income             | (1.8)    | 3.1    | (3.8)    | (2.5)    |
| Interest and other income/(expense) |          |        | 0.3      | 0.3      |
| Income taxes                        |          |        |          |          |
| Loss on discontinued operations     |          |        |          |          |
| Net (loss)/income                   | \$ (1.8) | \$ 3.1 | \$ (3.5) | \$ (2.2) |
| Capital investments                 | \$ 0.5   | \$ 0.1 | \$ 0.2   | \$ 0.8   |

**Table of Contents**

| (In millions)  | Segment Reporting<br>Nine Months Ended September 25, 2010 |  |           |           |
|--|---|--|-----------|-----------|
|  | Behavioral<br>Analytics<br>Service<br>Business<br>Unit    | Integrated<br>Contact<br>Solutions<br>Business<br>Unit | Corporate | Total     |
| Revenue  |   |  |           |           |
| Services   | \$ 20.2   | \$ 32.2  | \$        | \$ 52.4   |
| Product  |   | 10.2   |           | 10.2      |
| Net revenue  | 20.2  | 42.4   |           | 62.6      |
| Reimbursed expenses  | 0.4   | 2.3  |           | 2.7       |
| Total revenue  | 20.6  | 44.7   |           | 65.3      |
| Segment operating (loss)/income before stock-based compensation, severance and related costs and depreciation and amortization | (2.2)   | 5.7  | (6.3)     | (2.8)     |
| Stock-based compensation   | 2.5   | 1.1  | 0.9       | 4.5       |
| Severance and related costs  |   |  | 0.9       | 0.9       |
| Depreciation and amortization  |   |  | 3.1       | 3.1       |
| Operating (loss)/income  | (4.7)   | 4.6  | (11.2)    | (11.3)    |
| Interest and other (expense)/income  |   |  | (0.1)     | (0.1)     |
| Income taxes   |   |  | (0.1)     | (0.1)     |
| Loss on discontinued operations  |   |  | (0.1)     | (0.1)     |
| Net (loss)/income  | \$ (4.7)  | \$ 4.6   | \$ (11.5) | \$ (11.6) |
| Capital investments  | \$ 0.9  | \$ 1.5   | \$ 0.2    | \$ 2.6    |

| (In millions)  | Segment Reporting<br>Nine Months Ended September 26, 2009 |  |           |         |
|--|---|--|-----------|---------|
|  | Behavioral<br>Analytics<br>Service<br>Business<br>Unit    | Integrated<br>Contact<br>Solutions<br>Business<br>Unit | Corporate | Total   |
| Revenue  |   |  |           |         |
| Services   | \$ 14.9   | \$ 44.9  | \$        | \$ 59.8 |
| Product  |   | 14.8   |           | 14.8    |
| Net revenue  | 14.9  | 59.7   |           | 74.6    |
| Reimbursed expenses  | 0.2   | 2.8  |           | 3.0     |
| Total revenue  | 15.1  | 62.5   |           | 77.6    |
| Segment operating (loss)/income before stock-based compensation, severance and related costs and depreciation and amortization | (3.2)   | 10.7   | (6.3)     | 1.2     |
| Stock-based compensation   | 2.6   | 1.2  | 0.9       | 4.7     |
| Severance and related costs  |   |  | 1.0       | 1.0     |
| Depreciation and amortization  |   |  | 3.4       | 3.4     |
| Operating (loss)/income  | (5.8)   | 9.5  | (11.6)    | (7.9)   |
| Interest and other income/(expense)  |   |  | 0.1       | 0.1     |
| Income taxes   |   |  |           |         |

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Loss on discontinued operations

|                     |          |        |           |          |
|---------------------|----------|--------|-----------|----------|
| Net (loss)/income   | \$ (5.8) | \$ 9.5 | \$ (11.5) | \$ (7.8) |
| Capital investments | \$ 3.0   | \$ 0.4 | \$ 0.5    | \$ 3.9   |

**Table of Contents****Note Fifteen Fair Value Measurements**

The Company reports certain assets and liabilities at fair value. Fair value is an exit price and establishes a three-tier valuation hierarchy for ranking the quality and reliability of the information used to determine fair values. The first tier, Level 1, uses quoted market prices in active markets for identical assets or liabilities. Level 2 uses inputs, other than quoted market prices for identical assets or liabilities in active markets, which are observable either directly or indirectly. Level 3 uses unobservable inputs in which there are little or no market data, and requires the entity to develop its own assumptions. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

The following table provides the assets and liabilities carried at fair value measured on a recurring basis:

| (In millions)     | Fair Value Measurements at September 25, 2010 Using |   |                            |                                    |
|-------------------|---|---|----------------------------|------------------------------------|
|                   | Total carrying at Sept. 25, 2010                    | Quoted Prices in Active Markets (Level 1) | Other Observable (Level 2) | Significant Unobservable (Level 3) |
| Money market fund | \$ 11.5   | \$ 11.5                                   | \$                         | \$                                 |

| (In millions)     | Fair Value Measurements at December 26, 2009 Using |   |                            |                                    |
|-------------------|--|---|----------------------------|------------------------------------|
|                   | Total carrying at Dec. 26, 2009                    | Quoted Prices in Active Markets (Level 1) | Other Observable (Level 2) | Significant Unobservable (Level 3) |
| Money market fund | \$ 23.5  | \$ 23.5                                   | \$                         | \$                                 |

During fiscal year 2009, the Company sold its equity securities in a publicly-traded company for \$0.3 million. These marketable securities were classified as available for sale and were included in Other current assets on the Company's balance sheet. Unrealized holding gains and losses were excluded from earnings and reported in other comprehensive income until realized.

**Note Sixteen Fair Value of Financial Instruments**

The carrying values of current assets and liabilities approximated their fair values as of September 25, 2010 and December 26, 2009. The Company considers all highly liquid investments readily convertible into known amounts of cash (with purchased maturities of three months or less) to be cash equivalents.

**Note Seventeen Recent Accounting Pronouncements**

In October 2009, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2009-13, Revenue Recognition (Accounting Standards Codification ASC Topic 605) Multiple-Deliverable Revenue Arrangements, a consensus of the FASB Emerging Issues Task Force. This guidance modifies the fair value requirements of ASC subtopic 605-25, Revenue Recognition-Multiple Element Arrangements, by allowing the use of the best estimate of selling price in addition to VSOE and vendor objective evidence ( VOE ) (now referred to as TPE, standing for third-party evidence) for determining the selling price of a deliverable. A vendor is now required to use its best estimate of the selling price when VSOE or TPE of the selling price cannot be determined. In addition, the residual method of allocating arrangement consideration is no longer permitted.

In October 2009, the FASB also issued ASU No. 2009-14, Software (ASC Topic 985) Certain Revenue Arrangements That Include Software Elements, a consensus of the FASB Emerging Issues Task Force. This guidance modifies the scope of ASC subtopic 965-605, Software-Revenue Recognition, to exclude from its requirements (a) non-software components of tangible products and (b) software components of tangible products that are sold, licensed, or leased with tangible products when the software components and non-software components of the tangible product function together to deliver the tangible product's essential functionality.



## **Table of Contents**

ASU No. 2009-13 and ASU No. 2009-14 require expanded qualitative and quantitative disclosures and are effective for fiscal years beginning on or after June 15, 2010. However, companies were permitted to elect to adopt these expanded disclosures as early as interim periods ended September 30, 2009. These updates may be applied either prospectively from the beginning of the fiscal year for new or materially modified arrangements or retrospectively. We are currently evaluating the impact of adopting these updates on our consolidated financial statements.

In January 2010, the FASB issued ASU No. 2010-06, which provides new guidance related to the disclosures about transfers into and out of Levels 1 and 2 fair value classifications and separate disclosures about purchases, sales, issuances, and settlements relating to the Level 3 fair value classification. The Company's financial assets and liabilities are typically measured using Level 1 inputs. The new guidance also clarifies existing fair value disclosures about the level of disaggregation and about inputs and valuation techniques used to measure the fair value. In addition, the new guidance amends guidance on employers' disclosures about post-retirement benefit plan assets to require that disclosures be provided by classes of assets instead of by major categories of assets. The adoption of this guidance did not have an impact on our consolidated financial statements.

In February 2010, the FASB issued an amendment to the guidance on Subsequent Events, ASU No. 2010-09, which removed the requirement for an SEC registrant to disclose the date through which subsequent events are evaluated. It did not change the accounting for or disclosure of events that occur after the balance sheet date but before the financial statements are issued. This amendment was effective upon issuance. The adoption of ASU No. 2010-09 had no material effect on our consolidated financial statements.

In April 2010, the FASB issued ASU No. 2010-17, Revenue Recognition (ASC 605). This update provides guidance on the criteria that should be met for determining whether the milestone method of revenue recognition is appropriate. This guidance became effective for fiscal years, and interim periods within those years, beginning on or after June 15, 2010. We are currently evaluating the impact of adopting these updates on our consolidated financial statements.

In July 2010, the FASB issued ASU No. 2010-20, Receivables (ASC 310). This guidance relates to the credit quality of financing receivables and the allowance for credit losses. This guidance will require additional disclosures about the credit quality of financing receivables in the financial statements including, but not limited to, significant purchases and sales of financing receivables, aging information, and credit quality indicators. The additional disclosures will be effective for periods ending on or after December 15, 2010. We are currently evaluating the impact of adopting these updates on our consolidated financial statements.

During 2010, the FASB issued several ASUs, ASU No. 2010-01 through ASU No. 2010-25, and during 2009, ASU No. 2009-02 through ASU No. 2009-17. Except for ASUs No. 2009-13, 2009-14, 2010-06, 2010-09, 2010-17 and 2010-20 the ASUs entail technical corrections to existing guidance or affect guidance related to specialized industries and therefore have minimal, if any, impact on the Company.

### **Note Eighteen    Litigation and Other Contingencies**

From time to time, the Company has been subject to legal claims arising in connection with its business. While the results of these claims cannot be predicted with certainty, there are no asserted claims against the Company that, in the opinion of management, if adversely decided, would have a material effect on the Company's financial position, results of operations, or cash flows.

The Company is a party to various agreements, including substantially all major services agreements and intellectual property licensing agreements, under which it may be obligated to indemnify the other party with respect to certain matters, including, but not limited to, indemnification against third-party claims of infringement of intellectual property rights with respect to software and other deliverables provided by us in the course of our engagements. These obligations may be subject to various limitations on the remedies available to the other party, including, without limitation, limits on the amounts recoverable and the time during which claims may be made, and may be supported by indemnities given to the Company by applicable third parties. Payment by the Company under these indemnification clauses is generally subject to the other party making a claim that is subject to challenge by the Company and dispute resolution procedures specified in the particular agreement. Historically, the Company has not been obligated to pay any claim for indemnification under its agreements and management is not aware of future indemnification payments that it would be obligated to make.

**Table of Contents**

Under its By-Laws, subject to certain exceptions, the Company has agreed to indemnify its officers and directors for certain events or occurrences while the officer or director is, or was, serving at its request in such capacity or in certain related capacities. The Company has separate indemnification agreements with each of its directors and officers that requires it, subject to certain exceptions, to indemnify them to the fullest extent authorized or permitted by its By-Laws and the Delaware General Corporation Law. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a director and officer liability insurance policy that limits its exposure and enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal. The Company has no liabilities recorded for these agreements as of September 25, 2010.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Critical Accounting Policies and Estimates**

Our management's discussion and analysis of financial condition and results of operations is based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue, and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to the costs and timing of completion of client projects, our ability to collect accounts receivable, the timing and amounts of expected payments associated with cost reduction activities, and the ability to realize our net deferred tax assets, contingencies, and litigation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our condensed consolidated financial statements.

***Revenue Recognition***

***Behavioral Analytics Service Business Unit***

**Behavioral Analytics Service Line**

Managed services revenue included in the Behavioral Analytics Service Line consists of planning, deployment, training, and subscription fees. Planning, deployment, and training fees, which are considered to be installation fees related to long-term subscription contracts, are deferred until an installation is complete and are then recognized over the term of the applicable subscription contract. The terms of these subscription contracts generally range from three to five years. Installation costs incurred are deferred up to an amount not to exceed the amount of deferred installation revenue and additional amounts that are recoverable based on the contractual arrangement. These costs are included in Prepaid expenses and Other long-term assets. Such costs are amortized over the term of the subscription contract. Costs in excess of the foregoing revenue amount are expensed in the period incurred.

The amount of revenue generated from Behavioral Analytics Service subscription fees is based on a number of factors, such as the number of agents accessing the Behavioral Analytics System and/or the number of hours of calls analyzed during the relevant month of the term of the subscription contract. This revenue is recognized as the service is performed for the client.

Consulting services revenue included in the Behavioral Analytics Service Line primarily consists of fees charged to our clients to provide post-deployment follow-on consulting services, which generally consist of custom data analysis, the implementation of enhancements, and training. These follow-on consulting services are generally performed for our clients on a fixed-fee basis. Revenue is recognized as the services are performed with performance generally assessed on the ratio of actual hours incurred to date compared to the total estimated hours over the entire term of the contract.



## **Table of Contents**

### **Marketing Managed Services Line**

Marketing Managed Services revenue is derived from marketing application hosting and email fulfillment. Revenue related to hosting services is generally in the form of a fixed monthly fee received from our clients and is recognized as the services are performed for the client. Any related setup fee would be recognized over the term of the hosting contract. Revenue related to email fulfillment services is recognized as the services are provided to the client, based on the number of emails distributed for the client.

### ***Integrated Contact Solutions Business Unit***

#### **Integrated Contact Solutions Service Line**

Managed services revenue included in the Integrated Contact Solutions Service Line consists of fees generated from our contact center support and monitoring services. Support and monitoring fees are generally contracted for a fixed fee, and the revenue is recognized ratably over the term of the contract. Support fees that are contracted on a time-and-materials basis are recognized as the services are performed for the client.

For fixed price Managed services contracts where the Company provides support for third-party software and hardware, revenue is recorded at the gross amount of the sale. If the contract does not meet the requirements for gross reporting, then Managed services revenue is recorded at the net amount of the sale.

Consulting services revenue included in the Integrated Contact Solutions Service Line consists of the modeling, planning, configuring, or integrating of an IP network solution within our clients' contact center environments. These services are provided to the client on a time-and-materials or fixed-fee basis. For the integration of a system, the Company recognizes revenue as the services are performed, with performance generally assessed on the ratio of hours incurred to date compared to the total estimated hours over the entire term of the contract. For all other consulting services, we recognize revenue as the services are performed for the client.

Revenue from the sale of Product, which is generated primarily from the resale of third-party software and hardware by the Company, is generally recorded at the gross amount of the sale.

Within the Integrated Contact Solutions Service Line, Consulting services, Managed services, and the resale of Product may be sold and delivered together. In arrangements that include the resale of software, VSOE must be determined for each of the individual elements. If VSOE does not exist for the allocation of revenue to the various elements of the arrangement, then all revenue from the arrangement is deferred until all elements of the arrangement without VSOE have been delivered to the client. If the remaining undelivered elements are PCS or other deliverables with similar attribution periods, then the arrangement revenue is recognized ratably over the remaining service period.

#### **Traditional CRM Service Line**

Consulting services revenue included in the Company's traditional CRM Service Line consists of fees generated from our operational consulting and systems integration services or from building systems for our clients. These services are provided to our clients on a time-and-materials or fixed-fee basis. For the integration or building of a system, the Company recognizes revenue as the services are performed, with performance generally assessed on the ratio of hours incurred to date compared to the total estimated hours over the entire term of the contract. For all other consulting services, we recognize revenue as the services are performed for the client.

Managed services revenue included in the traditional CRM Service Line consists of fees generated from our remote application support. Contracts for remote application support can be based on a fixed-fee or time-and-materials basis. For fixed-fee support revenue is recognized ratably over the contract period. For time-and-material contracts revenue is recognized as the services are provided to the client.

Multiple-element arrangements are segmented into separate earning processes when the elements have objective and reliable evidence of fair value and have value to the customer on a stand-alone basis. Revenue related to contracts with multiple elements is allocated based on the fair value of the element and is recognized in accordance with our revenue recognition policy for each type of element, as described above. If the fair value for any undelivered element cannot be established, then revenue is deferred until all elements have been delivered to the client. If PCS or similar services are the only remaining activity without established fair value, then the revenue for the entire arrangement is recognized ratably over the service period.



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## **Table of Contents**

Reimbursed expenses revenue includes billable costs related to travel and other out-of-pocket expenses incurred while performing services for our clients. The cost of third-party product and support may be included within this category if the transaction does not satisfy the requirements for gross reporting. An equivalent amount of reimbursable expenses is included in Cost of revenue.

Payments received for Managed services contracts in excess of the amount of revenue recognized for these contracts are recorded as unearned revenue until revenue recognition criteria are met.

If the Company's estimates indicate that a contract loss will occur, then a loss provision is recorded in the period in which the loss first becomes probable and can reasonably be estimated.

The Company maintains allowances for doubtful accounts for estimated losses resulting from clients not paying for unpaid or disputed invoices for contractual services provided. Additional allowances may be required if the financial condition of our clients deteriorates.

### ***Stock-Based Compensation***

Stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the vesting period. Determining fair value of stock-based awards at the grant date requires certain assumptions. The Company uses historical information as the primary basis for the selection of expected life, expected volatility, expected dividend yield assumptions, and anticipated forfeiture rates. The risk-free interest rate is selected based on the yields from U.S. Treasury Strips with a remaining term equal to the expected term of the options being valued.

### ***Severance and Related Costs***

We recorded accruals for severance and related costs associated with our cost-reduction efforts undertaken during fiscal years 2001 through 2010. The portion of the accruals relating to employee severance represents contractual severance for identified employees and generally is not subject to a significant revision. The portion of the accruals that related to office space reductions, office closures, and associated contractual lease obligations are based in part on assumptions and estimates of the timing and amount of sublease rentals, which may be affected by overall economic and local market conditions. To the extent estimates of the success of our sublease efforts changed, adjustments increasing or decreasing the related accruals have been recognized. There was no adjustment made to sublease efforts in the first nine months of 2010, compared to a favorable adjustment of \$0.1 million in fiscal year 2009.

### ***Income Taxes***

We have recorded income tax valuation allowances on our net deferred tax assets to account for the unpredictability surrounding the timing of realization of our U.S. and non-U.S. net deferred tax assets due to uncertain economic conditions. The valuation allowances may be reversed at a point in time when management determines realization of these tax assets has become more likely than not, based on a return to predictable levels of profitability.

The Company uses an asset and liability approach for financial accounting and reporting of income taxes. Deferred income taxes are provided when tax laws and financial accounting standards differ with respect to the amount of income for the year, the basis of assets and liabilities and for tax loss carryforwards. The Company does not provide U.S. deferred income taxes on earnings of U.S. or foreign subsidiaries, which are expected to be indefinitely reinvested.

In July 2006, FASB addressed whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under this guidance, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. Significant judgment is used to determine the likelihood of the benefit. There is additional guidance on derecognition, classification, interest, and penalties on income taxes, accounting in interim periods, and disclosure requirements.

## **Table of Contents**

### ***Other Significant Accounting Policies***

For a description of the Company's other significant accounting policies, see Note Two – Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements included in our Annual Report filed on Form 10-K for the year ended December 26, 2009.

### **Forward-Looking Statements**

This Quarterly Report on Form 10-Q (this Form 10-Q) contains forward-looking statements that are based on current management expectations, forecasts, and assumptions. These include, without limitation, statements containing the words believes, anticipates, estimates, expects, plans, intends, projects, future, should, could, seeks, target, may, will continue to, predicts, forecasts, potential, guidance, expressions, references to plans, strategies, objectives, and anticipated future performance, and other statements that are not strictly historical in nature. These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or implied by the forward-looking statements. Such risks, uncertainties, and other factors that might cause such a difference include, without limitation, those noted under Risk Factors included in Part I Item 1A of Form 10-K for the year ended December 26, 2009, as well as the following:

Uncertainties associated with the attraction of new clients, the continuation of existing and new engagements with existing clients, and the timing of related client commitments;

Reliance on a relatively small number of clients for a significant percentage of our revenue;

Risks involving the variability and predictability of the number, size, scope, cost, and duration of, and revenue from, client engagements;

Variances in sales of products in connection with client engagements;

Management of the other risks associated with increasingly complex client projects and new service offerings, including execution risk;

Management of growth and development and introduction of new service offerings, including those related to the Behavioral Analytics Service;

Challenges in attracting, training, motivating, and retaining highly-skilled management, strategic, technical, product development, and other professional employees in a competitive information-technology labor market;

Risks associated with our reliance on Cisco Systems, Inc., a large primary product partner within our Integrated Contact Solutions Service Line, including our reliance on its product positioning, pricing, and discounting strategies;

Reliance on major suppliers, including CRM software providers and other alliance partners, and maintenance of good relations with key business partners;

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Continuing intense competition in the information-technology services industry generally and, in particular, among those focusing on the provision of CRM services and software;

The rapid pace of technological innovation in the information-technology services industry;

Protection of our technology, proprietary information, and other intellectual property rights from challenges by others;

The ability to raise sufficient amounts of debt or equity capital to meet our future operating and financial needs;

The outcome of strategic alternatives being evaluated with respect to our Integrated Contract Solutions Business Unit;

Risks associated with compliance with international, federal, and state privacy and security laws, and the protection of highly confidential information of clients and their customers;

Future legislative or regulatory actions relating to information technology or the information-technology service industry, including those relating to data privacy and security;

Changes by the FASB or the SEC of authoritative accounting principles generally accepted in the United States or policies or changes in the application or interpretation of those rules or regulations;

**Table of Contents**

Risks associated with global operations, including those relating to the economic conditions in each country, potential currency exchange and credit volatility, compliance with a variety of foreign laws and regulations, and management of a geographically-dispersed organization;

Economic, business, and political conditions and the effects of these conditions on our clients' businesses and levels of business activity;

Acts of war or terrorism, including, but not limited to, actions taken or to be taken by the United States and other governments as a result of acts or threats of terrorism, and the impact of these acts on economic, financial, and social conditions in the countries where we operate; and

The timing and occurrence (or non-occurrence) of transactions and events which may be subject to circumstances beyond our control. Readers are cautioned not to place undue reliance on forward-looking statements. They reflect opinions, assumptions, and estimates only as of the date they are made, and the Company undertakes no obligation to publicly update or revise any forward-looking statements in this Form 10-Q, whether as a result of new information, future events, or circumstances or otherwise.

**Background**

eLoyalty helps its clients achieve breakthrough results with revolutionary analytics and advanced technologies that drive continuous business improvement. With a long track record of delivering proven solutions for many of the *Fortune* 1000 companies, the Company's offerings include the Behavioral Analytics Service, Integrated Contact Solutions, and Consulting Services, aligned to enable focused business transformation.

The Company is focused on growing and developing its business through two primary Business Units: the Behavioral Analytics Service and Integrated Contact Solutions. Through these Business Units, the Company generates three types of revenue: (1) Managed services revenue, which is recurring, annuity revenue from long-term (generally one- to five-year) contracts; (2) Consulting services revenue, which is generally project-based and sold on a time-and-materials or fixed-fee basis; and (3) Product revenue, which is generated through the resale of third-party software and hardware. The chart below shows the relationship between these Business Units and the types of revenue generated from each.

| <b>Business Unit</b>                    | <b>Managed Services<br/>Revenue</b>  | <b>Consulting Services<br/>Revenue</b> | <b>Product<br/>Revenue</b> |
|---|--|--|----------------------------|
| <b>Behavioral<br/>Analytics Service</b> | Subscription and amortized<br>deployment revenue;<br>marketing application<br>hosting and email fulfillment<br>revenue | Follow-on consulting<br>revenue        | None                       |

|   |  |  |
|---|--|--|
| <b>Integrated Contact<br/>Solutions</b> | System integration revenue   | Hardware and software  |
|   | for the Integrated Contact<br>Solutions Service Line;<br>consulting revenue for the<br>traditional CRM Service<br>Line | resale revenue, primarily<br>from products of<br>Cisco Systems |
|   | Contact center monitoring<br>and support revenue; remote<br>application support revenue                                |  |

In recent years, the Company has invested to develop the following differentiated capabilities in our primary Business Units:

**Table of Contents**

*Behavioral Analytics Service Business Unit*

**Behavioral Analytics™ Service Line**

eLoyalty pioneered this solution, which improves the reliability of call recording and applies human behavioral modeling to analyze and improve customer interactions, primarily in the contact center environment. Using the Behavioral Analytics Service, eLoyalty can help clients:

Automatically measure customer satisfaction and agent performance on every call;

Identify and understand customer personality;

Improve rapport between agent and customer;

Reduce call handle times while improving customer satisfaction;

Identify opportunities to improve self-service applications;

Improve cross-sell and up-sell success rates;

Improve the efficiency and effectiveness of collection efforts; and

Measure and improve supervisor effectiveness and coaching.

eLoyalty has designed a scalable application platform to enable the Company to implement and operate the Behavioral Analytics Service for its clients. The Behavioral Analytics Service is primarily hosted by eLoyalty and delivered as a managed subscription service. Managed services revenue includes deployment and subscription services. Consulting services revenue includes post-deployment follow-on services, generally consisting of custom data analysis.

**Marketing Managed Services Line**

Marketing Managed Services revenue is derived from marketing application hosting and email fulfillment services.

*Integrated Contact Solutions Business Unit*

**Integrated Contact Solutions Service Line**

The Company's Integrated Contact Solutions Service Line focuses on helping clients improve customer service business performance through the implementation of the following solution offerings:



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Cisco VoIP (Voice over Internet Protocol) Solutions clients realize the benefits of transitioning their contact centers and corporate telephony to a single VoIP network infrastructure from the traditional two-network (voice network and separate data network) model. These benefits include cost savings, remote agent flexibility, and application enhancements. The Company has developed a set of tools and methodologies to help clients financially model, plan, configure, integrate, and support Converged IP network solutions within their contact center environments.

Managed Support Services clients realize the benefits of proactive monitoring of their contact center and telephony platforms and networks to avoid system degradation and downtime that can effect business operations. We also provide 24x7 maintenance services and operations and applications services to help enhance, administer, and manage VoIP contact center and telephony platforms that include technology from Cisco Systems and other third-party vendors.

Business Application Services clients realize the benefits of reduced average handle time, improved first call resolution, and improved self-service automation for customer calls to the call center, as well as reduced training costs for call center agents.

### **Traditional CRM Service Line**

The Company's traditional CRM Service Line focuses on operational consulting to enhance customer service business performance through improved process efficiencies, redesign of workflows, and improved contact center operations and workforce management. We also generate Managed services revenue from this Service Line by providing remote application support to clients.

## **Table of Contents**

### **Types of Revenue**

Managed services, Consulting services, and the resale of Product are frequently sold and delivered together. Consulting services engagements relating to the design and implementation of customer service or marketing solutions may lead to the sale of one of our Managed services, which may also include a long-term maintenance and support or hosting relationship and the sale of Product.

### ***Managed Services***

Growth in Managed services revenue is primarily driven by the sale of Behavioral Analytics Service and Integrated Contact Solutions engagements. These Managed services are described below:

The Behavioral Analytics Service includes the deployment and ongoing operation of our proprietary Behavioral Analytics System. Based on each client's business requirements, the Behavioral Analytics System is configured and integrated into the client's environment and then deployed in either a remote-hosted or, in one case, an on-premise hosted environment. The Behavioral Analytics Service is provided on a subscription basis and the contract duration generally is three to five years. The fees and costs related to the initial deployment are deferred and amortized over the term of the contract.

Contact Center Managed Services include monitoring and support related to complex IP and traditional contact center voice architectures. These services include routine maintenance and technology upgrades and the resolution of highly complex issues that involve multiple technology components and vendors. Our support and monitoring services reduce the cost and impact of contact center downtime for our clients and anticipate problems before they occur.

In addition, we also generate Managed services revenue from two other sources. Marketing Managed Services revenue is generated from hosted customer and campaign data management and mass email fulfillment services. We also continue to provide remote call center application support and maintenance services to a small number of long-term clients. These two sources of Managed services revenue are likely to diminish over time as we focus on growth through the Behavioral Analytics Service and Integrated Contact Solutions Service Lines.

### ***Consulting Services***

In addition to the Consulting services revenue generated by Behavioral Analytics Service and Integrated Contact Solutions engagements, we derive a portion of our revenue from a broad range of traditional CRM consulting work with long-standing accounts, as well as newer accounts more recently obtained through our Behavioral Analytics Service and Integrated Contact Solutions Service Lines. Our Consulting services are billed on a time-and-materials basis or on a fixed-fee basis and generally include a combination of the following:

Evaluating our clients' efficiency and effectiveness in handling customer interactions. We observe, measure, and analyze the critical aspects of each customer interaction, including the number of legacy systems used to handle the situation, interaction time, reason for interaction, and actions taken to resolve any customer issues.

Performing detailed financial analysis to calculate the expected return on investment for the implementation of various Customer Service / CRM solutions. This process helps our clients establish goals, alternatives, and priorities and assigns client accountability throughout resulting projects.

Implementing the operations, process, and human performance aspects of Customer Service / CRM solutions.

### ***Product***

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We also generate revenue from the resale of Product, which consists of software and hardware sold through our Integrated Contact Solutions Service Line. The vast majority of this revenue relates to reselling products from Cisco Systems, Inc.

### **Business Outlook**

In the fourth quarter of 2010, we expect our Managed services revenue to grow compared to the third quarter of 2010. This expectation is derived from the timing of revenue recognition from our existing Managed services backlog and anticipated contract renewals from existing clients, as well as anticipated revenue recognition from potential clients included in our sales pipeline. Overall, 2010 Managed services revenue is expected to be higher than in 2009.

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**Table of Contents**

Consulting services revenue is anticipated to be essentially flat in the fourth quarter of 2010 compared to the third quarter of 2010. This expectation is based on timing of revenue recognition from existing client projects and anticipated revenue recognition from Consulting services contracts expected to be signed in the fourth quarter of 2010. Overall, Consulting services revenue is expected to decline in 2010 compared to 2009.

Product revenues are highly variable and we currently expect these revenues will be lower in the fourth quarter of 2010 compared to the third quarter of 2010. This expectation is based on anticipated timing of revenue recognition from potential Product resale opportunities in our sales pipeline. Overall, 2010 Product revenue is expected to decline compared to 2009.

We continue to invest in the personnel required to sell and manage complex, long-term relationships in our primary Service Lines. In particular, we continue to make significant investments in the resources required to develop, deliver, and support our Behavioral Analytics Service. These investments may affect our profitability and cash resources in the fourth quarter of 2010 and in 2011, but we believe they are required to continue to build our Behavioral Analytics Service, to increase our Managed services backlog, and to maintain and strengthen our competitive advantage.

Management will continue to assess all areas of the cost structure to identify opportunities to maximize cash resources and profitability. We will also continue to evaluate strategic opportunities with respect to our Business Units. In June 2010, we retained a financial advisor to assist the Company in exploring alternatives with respect to the Integrated Contract Solutions Business Unit. We continue to pursue and evaluate opportunities that may result in the sale or other divestiture of the Business Unit.

Our results of operations may be affected by general economic conditions. We continue to monitor economic conditions and levels of business confidence and their potential effect on our Company and clients. A severe and/or prolonged economic downturn could adversely affect our clients' financial conditions and the levels of business activities in the industries and geographies where we operate. This may reduce demand for our services or depress pricing of those services and have a material adverse effect on our new contract bookings and results of operations. Particularly in light of recent economic uncertainty, we continue to monitor costs closely in order to respond to changing conditions and to manage any impact to our results of operations.

***Managed Services Backlog***

As a result of the strategic and long-term nature of Managed services revenue, we believe it is appropriate to monitor the level of backlog associated with these agreements. The Managed services backlog was \$107.0 million as of September 25, 2010 and \$87.7 million as of December 26, 2009. The increase in backlog is primarily due to the signing of several Integrated Contact Solutions support agreements and several Behavioral Analytics Service agreements in the first half of 2010. Of the September 25, 2010 backlog, 55% is related to our Behavioral Analytics Service Business Unit and 45% is related to our Integrated Contact Solutions Business Unit. The Company anticipates an increase in Managed services backlog in fiscal year 2010.

The Company uses the term *backlog* to reflect the estimated future amount of Managed services revenue related to its Managed services contracts. The value of these contracts is based on anticipated usage volumes over the anticipated term of the agreement. The anticipated term of the agreement is based on the contractually agreed fixed term of the contract, plus agreed upon, but optional, extension periods. Anticipated volumes may be greater or less than anticipated. In addition, these contracts typically are cancellable without cause provided the customer makes a substantial early termination payment or forfeits prepaid contract amounts. The reported backlog is expected to be recognized as follows: \$13.7 million in 2010; \$42.9 million in 2011; \$29.7 million in 2012; and \$20.7 million in 2013 and thereafter.

**Table of Contents****Third Quarter 2010 Compared with Third Quarter 2009*****Net Revenue***

|                         | 2010                   |                     | Third Quarter<br>2009  |                     |
|-------------------------|------------------------|---------------------|------------------------|---------------------|
|                         | Dollars in<br>Millions | % of Net<br>Revenue | Dollars in<br>Millions | % of Net<br>Revenue |
| <b>Revenue:</b>         |                        |                     |                        |                     |
| Managed services        | \$ 13.6                | 61%                 | \$ 12.7                | 59%                 |
| Consulting services     | 4.5                    | 20%                 | 7.0                    | 32%                 |
| <b>Services revenue</b> | <b>18.1</b>            | <b>81%</b>          | <b>19.7</b>            | <b>91%</b>          |
| Product                 | 4.2                    | 19%                 | 2.0                    | 9%                  |
| <b>Net revenue</b>      | <b>22.3</b>            | <b>100%</b>         | <b>21.7</b>            | <b>100%</b>         |
| Reimbursed expenses     | 1.0                    |                     | 1.0                    |                     |
| <b>Total revenue</b>    | <b>\$ 23.3</b>         |                     | <b>\$ 22.7</b>         |                     |

Net revenue is total revenue excluding reimbursable expenses that are billed to our clients. Our net revenue increased 3% to \$22.3 million in the third quarter of 2010, an increase of \$0.6 million from \$21.7 million in the third quarter of 2009.

Revenue from Managed services was \$13.6 million in the third quarter of 2010, an increase of \$0.9 million, or 7%, from \$12.7 million in the third quarter of 2009. The increase in revenue from Managed services resulted from substantially higher Behavioral Analytics Service revenue, reflecting the transition of deployments to the subscription phase, partially offset by a decrease in revenue from our Integrated Contact Solutions Service Line. This decrease was driven by the cancellation of several existing support agreements during the last half of 2009, partially offset by additional agreements signed with new and existing clients during the last half of 2009 and the first nine months of 2010.

Revenue from Consulting services decreased by \$2.5 million in the third quarter of 2010 to \$4.5 million, from \$7.0 million in the third quarter of 2009, a decrease of 36%. The decrease in revenue was mainly due to the decline in our traditional CRM Service Line, driven by reduced spending by our largest clients that utilize these services, and a decline in revenue from our Integrated Contact Solutions Service Line, driven by the completion of several large projects that were in progress in the third quarter of 2009. Spending by our clients that utilize our Consulting services may fluctuate between periods in all Service Lines due to the short-term nature of these engagements. Revenue from Consulting services is a product of billable hours and our average billable rate. Billable hours are largely a function of our billable headcount and utilization rates. eLoyalty's average billable rate increased to \$169 in the third quarter of 2010, from \$164 in the third quarter of 2009. This increase was the result of the higher mix of Integrated Contact Solutions Service Line projects, which have higher average billing rates than our traditional CRM Service Line. Headcount associated with our Consulting services decreased in the third quarter of 2010 compared to the third quarter of 2009 because of staff reductions associated with the decline in our traditional CRM Service Line and our Integrated Contact Solutions Service Line. Utilization of billable consultants, defined as billed time as a percentage of total available time, increased to 71% for the third quarter of 2010 from 67% for the third quarter of 2009.

Revenue from the sale of Product was \$4.2 million in the third quarter of 2010, an increase of \$2.2 million from \$2.0 million in the third quarter of 2009. There are significant variances in size among individual engagements within this Service Line, and the Company is not always selected as the Product supplier for its engagements. We resell Product to our clients to provide a complete solution when requested, but we do not focus our sales effort on driving Product revenue. As a result, annual and quarterly Product revenue may fluctuate significantly.

The Company's top five clients accounted for 35% of total revenue in the third quarter of 2010, compared to 36% in the third quarter of 2009. The top 10 clients accounted for 55% of total revenue in the third quarter of 2010, compared to 57% in the third quarter of 2009. The top 20 clients accounted for 75% of total revenue in the third quarter of 2010, compared to 76% of total revenue in the third quarter of 2009. In the third quarter of 2010 and in the third quarter of 2009, there were no clients that accounted for 10% or more of total revenue. Higher concentration of

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revenue with a single client or a limited group of clients creates increased revenue risk if one of these clients significantly reduces its demand for our services.

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**Table of Contents**

***Cost of Revenue Before Reimbursed Expenses, Exclusive of Depreciation and Amortization***

Cost of revenue before reimbursed expenses includes Cost of services and Cost of product, each of which is discussed below.

**Cost of Services**

Cost of services primarily consists of labor costs, including salaries, fringe benefits, and incentive compensation of our delivery personnel and Selling, general, and administrative personnel working on direct, revenue generation activities and third-party pass through costs related to our Managed services. Cost of services also includes employee costs for travel expenses, training, laptop computer leases, and other expenses of a non-billable nature. Cost of services excludes depreciation and amortization.

Cost of services in the third quarter of 2010 was \$10.6 million, or 59% of Services revenue, compared to \$13.0 million, or 66% of Services revenue, in the third quarter of 2009. The decrease in cost was largely due to reduced Integrated Contact Solutions subcontractor and compensation cost, driven by reduced revenue levels in the Integrated Contact Solutions Business Unit. The Cost of services percentage decreased primarily due to the impact of the cost reductions discussed above, higher utilization, and the higher average billing rate.

**Cost of Product**

Cost of product is the amount we pay our vendors for the third-party software and hardware that we resell, primarily through our Integrated Contact Solutions Service Line. Primary factors affecting Cost of product are Product revenue levels, the vendor specific mix of the products we resell within a period and our ability to qualify for rebates from Cisco, our largest product vendor.

Rebates fluctuate with the volume of Cisco product sold, and are based on a percentage of our cost for the product. Eligibility for these rebates is determined by our ability to meet vendor-established performance criteria, some of which are outside of our control. We recognize these rebates as they are earned as we have consistently met established criteria and can estimate the value of these rebates.

Cost of product in the third quarter of 2010 was \$3.6 million, or 86% of Product revenue, compared to \$1.4 million, or 68% of Product revenue in the third quarter of 2009. The cost increase corresponds to the increase in Product revenue. The percentage increase was primarily due to the mix of vendor-specific products sold in the third quarter of 2010 compared to the mix of vendor-specific products sold in the third quarter of 2009.

***Selling, General and Administrative***

Selling, general and administrative expenses consist primarily of salaries, incentive compensation, commissions, and employee benefits for business development, account management, solution development/support, marketing, and administrative personnel, as well as facilities costs, a provision for uncollectible amounts, and costs for our technology infrastructure and applications. The personnel costs included here are net of any labor costs directly related to the generation of revenue, which are represented in Cost of services.

Selling, general and administrative expenses increased \$1.4 million to \$9.7 million in the third quarter of 2010, from \$8.3 million in the third quarter of 2009. This increase is primarily due to increased personnel costs to support our Behavioral Analytics Service Business Unit.

***Severance and Related Costs***

In 2010 and 2009, in response to the overall business environment, a number of cost reduction activities were undertaken, principally consisting of personnel reductions. Cash savings related to cost reduction actions taken in the third quarter of 2010 are anticipated to be \$0.9 million annually. The cost reduction actions taken in fiscal year 2009 resulted in annual cash savings of \$4.5 million. All severance and related costs associated with cost reduction activities are expected to be paid out by the end of the fourth quarter of 2010, pursuant to agreements entered into with affected employees. Facility costs related to office space reductions and office closures in 2008 will be paid pursuant to contractual lease terms through fiscal year 2015.

## **Table of Contents**

Severance and related costs was \$0.1 million in the third quarter of 2010 compared to \$0.3 million in the third quarter of 2009. The \$0.1 million of expense recorded in the third quarter of 2010 primarily related to restructuring actions taken in the third quarter of 2010 for the elimination of eight positions. In the third quarter of 2009, the Company recorded \$0.3 million of expense primarily related to the elimination of seven positions.

### ***Depreciation and Amortization***

Depreciation and amortization decreased \$0.1 million, or 9%, to \$1.0 million in the third quarter of 2010 compared to \$1.1 million in the third quarter of 2009. The decrease in depreciation and amortization is primarily related to assets becoming fully depreciated.

### ***Operating Loss***

Primarily as a result of the factors described above, we experienced an operating loss of \$2.7 million for the third quarter of 2010, compared to an operating loss of \$2.5 million for the third quarter of 2009.

### ***Interest and Other (Expense) Income, Net***

Non-operating interest and other (expense) income decreased by \$0.3 million, to less than \$0.1 million of expense in the third quarter of 2010 from \$0.3 million of income in the third quarter of 2009. In the third quarter of 2010, the less than \$0.1 million of expense was primarily related to interest expense for our capital lease obligations. In the third quarter of 2009, the \$0.3 million of income was primarily related to the gain from the sale of equity securities in a publicly-traded company.

### ***Income Tax (Provision) Benefit***

The income tax provision was less than \$0.1 million in the third quarter of 2010 and the income tax benefit was less than \$0.1 million in the third quarter 2009, respectively. As of September 25, 2010, total deferred tax assets of \$62.5 million were fully offset by a valuation allowance. The level of uncertainty in predicting when we will achieve profitability, sufficient to utilize our net U.S. and non-U.S. operating losses and realize our remaining deferred tax assets, requires that an income tax valuation allowance be recognized in the financial statements.

### ***Loss on Discontinued Operations***

There was no loss on discontinued operations for the third quarter of 2010 or in the third quarter of 2009.

### ***Net Loss Available to Common Stockholders***

We reported a net loss available to common stockholders of \$3.1 million in the third quarter of 2010 compared to a net loss available to common stockholders of \$2.5 million in the third quarter of 2009. These losses include accrued dividends to preferred stockholders of \$0.3 million in the third quarter of both 2010 and 2009. The net loss was \$0.22 per share on a basic and diluted basis in the third quarter of 2010, compared to a net loss of \$0.19 per share on a basic and diluted basis in the third quarter of 2009.



**Table of Contents****First Nine Months of 2010 Compared with First Nine Months of 2009*****Net Revenue***

|                         | Nine Months Ended      |                     |                        |                     |
|-------------------------|------------------------|---------------------|------------------------|---------------------|
|                         | September 25, 2010     |                     | September 26, 2009     |                     |
|                         | Dollars in<br>Millions | % of Net<br>Revenue | Dollars in<br>Millions | % of Net<br>Revenue |
| <b>Revenue:</b>         |                        |                     |                        |                     |
| Managed services        | \$ 39.4                | 63%                 | \$ 35.4                | 47%                 |
| Consulting services     | 13.0                   | 21%                 | 24.4                   | 33%                 |
| <b>Services revenue</b> | <b>52.4</b>            | <b>84%</b>          | <b>59.8</b>            | <b>80%</b>          |
| Product                 | 10.2                   | 16%                 | 14.8                   | 20%                 |
| <b>Net revenue</b>      | <b>62.6</b>            | <b>100%</b>         | <b>74.6</b>            | <b>100%</b>         |
| Reimbursed expenses     | 2.7                    |                     | 3.0                    |                     |
| <b>Total revenue</b>    | <b>\$ 65.3</b>         |                     | <b>\$ 77.6</b>         |                     |

Net revenue is total revenue excluding reimbursable expenses that are billed to our clients. Our net revenue decreased 16% to \$62.6 million in the first nine months of 2010, a decrease of \$12.0 million from \$74.6 million in the first nine months of 2009.

Revenue from Managed services was \$39.4 million in the first nine months of 2010, an increase of \$4.0 million, or 11%, from \$35.4 million in the first nine months of 2009. The increase in revenue from Managed services resulted from substantially higher Behavioral Analytics Service revenue, reflecting the transition of deployments to the subscription phase, partially offset by a decrease in revenue from our Integrated Contact Solutions Service Line. This decrease was driven by the cancellation of several existing support agreements during 2009, partially offset by additional agreements signed with new and existing clients during 2009 and the first nine months of 2010.

Revenue from Consulting services decreased by \$11.4 million in the first nine months of 2010 to \$13.0 million, from \$24.4 million in the first nine months of 2009, a decrease of 47%. The decrease in revenue was mainly due to the decline in our traditional CRM Service Line, driven by reduced spending by our largest clients that utilize these services, and a decline in revenue from our Integrated Contact Solutions Service Line, driven by the completion of several large projects that were in progress in the first nine months of 2009. Spending by our clients that utilize our Consulting services may fluctuate between periods in all Service Lines due to the short-term nature of these engagements. Revenue from Consulting services is a product of billable hours and our average billable rate. Billable hours are largely a function of our billable headcount and utilization rates. eLoyalty's average billable rate increased to \$170 in the first nine months of 2010, from \$164 in the first nine months of 2009. This increase was the result of a higher mix of Integrated Contact Solutions Service Line projects, which have higher average billing rates than our traditional CRM Service Line. Headcount associated with our Consulting services decreased in the first nine months of 2010 compared to the first nine months of 2009 because of staff reductions associated with the decline in our traditional CRM Service Line and our Integrated Contact Solutions Service Line. Utilization of billable consultants, defined as billed time as a percentage of total available time, decreased to 65% for the first nine months of 2010 from 70% for the first nine months of 2009. This decline was due to significantly lower utilization in the first quarter of 2010 due to delays in starting several new projects.

Revenue from the sale of Product was \$10.2 million in the first nine months of 2010, a decrease of \$4.6 million from \$14.8 million in the first nine months of 2009. This decrease is due to the impact of signing two large contracts in the first quarter of 2009. There are significant variances in size among individual engagements within this Service Line, and the Company is not always selected as the Product supplier for its engagements. We resell Product to our clients to provide a complete solution when requested, but we do not focus our sales effort on driving Product revenue. As a result, annual and quarterly Product revenue may fluctuate significantly.

The Company's top five clients accounted for 30% of total revenue in the first nine months of 2010, compared to 44% in the first nine months of 2009. The top 10 clients accounted for 45% of total revenue in the first nine months of 2010, compared to 60% in the first nine months of 2009.

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The top 20 clients accounted for 67% of total revenue in the first nine months of 2010, compared to 78% of total revenue in the first nine months of 2009. In the first nine months of 2010, there were no clients that accounted for 10% or more of total revenue. One client, Sears Holdings Management Corporation, accounted for 17% of total revenue in the first nine months of 2009. Higher concentration of revenue with a single client or a limited group of clients creates increased revenue risk if one of these clients significantly reduces its demand for our services.

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**Table of Contents**

***Cost of Revenue Before Reimbursed Expenses, Exclusive of Depreciation and Amortization***

Cost of revenue before reimbursed expenses includes Cost of services and Cost of product, each of which is discussed below.

**Cost of Services**

Cost of services primarily consists of labor costs, including salaries, fringe benefits, and incentive compensation of our delivery personnel and Selling, general, and administrative personnel working on direct, revenue generation activities and third-party pass through costs related to our Managed services. Cost of services also includes employee costs for travel expenses, training, laptop computer leases, and other expenses of a non-billable nature. Cost of services excludes depreciation and amortization.

Cost of services in the first nine months of 2010 was \$32.3 million, or 62% of Services revenue, compared to \$39.6 million, or 66% of Services revenue, in the first nine months of 2009. The decrease in cost was largely due to reduced Integrated Contact Solutions subcontractor, compensation, and travel cost driven by reduced revenue levels in the Integrated Contact Solutions Business Unit, partially offset by decreased cost deferrals for the Behavioral Analytics Service, net of amortized implementation costs. The Cost of services percentage decreased primarily due to the impact of the cost reductions discussed above, and the higher average billing rate, which were partially offset by reduced utilization due to lower Consulting services revenue.

**Cost of Product**

Cost of product is the amount we pay our vendors for the third-party software and hardware that we resell, primarily through our Integrated Contact Solutions Service Line. Primary factors affecting Cost of product are Product revenue levels, the vendor specific mix of the products we resell within a period and our ability to qualify for rebates from Cisco, our largest product vendor.

Rebates fluctuate with the volume of Cisco product sold, and are based on a percentage of our cost for the product. Eligibility for these rebates is determined by our ability to meet vendor-established performance criteria, some of which are outside of our control. We recognize these rebates as they are earned, because we have consistently met established criteria and can estimate the value of these rebates.

Cost of product in the first nine months of 2010 was \$8.5 million, or 83% of Product revenue, compared to \$12.5 million, or 84% of Product revenue in the first nine months of 2009. The cost decrease corresponds to the decrease in Product revenue. The percentage decrease was primarily due to the mix of vendor-specific products sold in the first nine months of 2010.

***Selling, General and Administrative***

Selling, general and administrative expenses consist primarily of salaries, incentive compensation, commissions, and employee benefits for business development, account management, solution development/support, marketing, and administrative personnel, as well as facilities costs, a provision for uncollectible amounts, and costs for our technology infrastructure and applications. The personnel costs included here are net of any labor costs directly related to the generation of revenue, which are represented in Cost of services.

Selling, general and administrative expenses increased \$3.1 million to \$29.1 million in the first nine months of 2010 from \$26.0 million in the first nine months of 2009. This increase is primarily due to increased personnel costs to support our Behavioral Analytics Service Business Unit.

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**Table of Contents*****Severance and Related Costs***

In 2010 and 2009, in response to the overall business environment, a number of cost reduction activities were undertaken, principally consisting of personnel reductions. Cash savings related to cost reduction actions taken in the first nine months of 2010 are anticipated to be \$6.4 million annually. The cost reduction actions taken in fiscal year 2009 resulted in annual cash savings of \$4.5 million. All severance and related costs associated with cost reduction activities are to be paid out by the end of the fourth quarter of 2010, pursuant to agreements entered into with affected employees. Facility costs related to office space reductions and office closures in 2008 will be paid pursuant to contractual lease terms through fiscal year 2015.

Severance and related costs was \$0.9 million in the first nine months of 2010 and \$1.0 million in the first nine months of 2009, respectively. The \$0.9 million of expense recorded in the first nine months of 2010 primarily related to restructuring actions taken in 2010 for the elimination of fifty-five positions. In the first nine months of 2009, the Company recorded \$1.0 million of expense primarily related to the elimination of twenty-six positions and an adjustment to sublease recoveries.

***Depreciation and Amortization***

Depreciation and amortization decreased \$0.3 million, or 9%, to \$3.1 million in the first nine months of 2010 compared to \$3.4 million in the first nine months of 2009. The decrease in depreciation and amortization is primarily related to Marketing Managed Services customer contracts becoming fully amortized in 2009.

***Operating Loss***

Primarily as a result of the factors described above, we experienced an operating loss of \$11.3 million for the first nine months of 2010, compared to an operating loss of \$7.9 million for the first nine months of 2009.

***Interest and Other (Expense) Income, Net***

Non-operating interest and other (expense) income decreased by \$0.2 million, to \$0.1 million of expense in the first nine months of 2010 from \$0.1 million of income in the first nine months of 2009. In the first nine months of 2010, the \$0.1 million of expense was primarily related to interest expense for our capital lease obligations. In the first nine months of 2009, the \$0.1 million of income was primarily due to a gain on the sale of equity securities in a publicly-traded company for \$0.3 million partially offset by \$0.2 million of interest expense for our capital lease obligations and lower average yields on our investments.

***Income Tax (Provision) Benefit***

The income tax provision was \$0.1 million in the first nine months of 2010 and less than \$0.1 million in the first nine months 2009, respectively. As of September 25, 2010, total deferred tax assets of \$62.5 million were fully offset by a valuation allowance. The level of uncertainty in predicting when we will achieve profitability, sufficient to utilize our net U.S. and non-U.S. operating losses and realize our remaining deferred tax assets, requires that an income tax valuation allowance be recognized in the financial statements.

***Loss on Discontinued Operations***

The loss on discontinued operations was \$0.1 million for the first nine months of 2010, which was related to the sale of a subsidiary in Switzerland. There was no loss on discontinued operations for the first nine months of 2009.

***Net Loss Available to Common Stockholders***

We reported a net loss available to common stockholders of \$12.5 million in the first nine months of 2010 compared to a net loss available to common stockholders of \$8.8 million in the first nine months of 2009. These losses include accrued dividends to preferred stockholders of \$1.0 million in the first nine months of both 2010 and 2009. The net loss was \$0.92 per share on a basic and diluted basis in the first nine months of 2010, compared to a net loss of \$0.66 per share on a basic and diluted basis in the first nine months of 2009.



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**Table of Contents****Liquidity and Capital Resources*****Introduction***

Our principal capital requirements are to fund working capital needs, capital expenditures for our Behavioral Analytics Service Line and infrastructure requirements, and other revenue generation and growth investments. As of September 25, 2010, our principal capital resources consisted of (1) our cash and cash equivalents balance of \$14.0 million, which includes \$1.4 million in foreign bank accounts, (2) restricted cash of \$3.7 million, and (3) the remaining \$1.3 million under the Bank Facility as defined below.

Our cash and cash equivalents position decreased \$15.0 million, or 52%, as of September 25, 2010, from \$29.0 million as of December 26, 2009. The decrease in cash in the first nine months of 2010 was primarily the result of the net loss before depreciation, amortization and stock-based compensation, a decrease in unearned revenue reflecting the recognition of previously deferred revenue, capital expenditures, cash dividend payments on Series B Stock, acquisition of treasury stock, and capital lease principal payments. Restricted cash remained constant at \$3.7 million for the first nine months of both 2010 and 2009 and was primarily used as collateral for letters of credit issued in support of future capital lease obligations. See Bank Facility below for a description of the contractual requirements related to restricted cash.

***Cash Flows from Operating Activities***

The Company used \$9.2 million of cash during the first nine months of 2010 and generated \$7.2 million of cash in operating activities during the first nine months of 2009. During the first nine months of 2010, cash outflows of \$9.2 million from operating activities consisted primarily of the net loss before depreciation, amortization, and stock-based compensation, and an increase in prepaid costs of \$7.8 million, which primarily consist of costs associated with unearned revenue, partially offset by unearned revenue of \$4.7 million as a result of customer prepayments.

During the first nine months of 2009, cash flows consisted primarily of higher unearned revenue of \$17.7 million, partially offset by higher prepaid costs associated with unearned revenue of \$5.2 million, higher Days Sales Outstanding ( DSO ) of \$2.4 million, and increased prepaid compensation of \$1.4 million.

DSO was 39 days at September 25, 2010 compared to 35 days at December 26, 2009, an increase of four days. We do not expect any significant collection issues with our clients; see Accounts Receivable Customer Concentration for additional information on cash collections. As of September 25, 2010, there remained \$0.3 million of unpaid severance and related costs. See Note Five Severance and Related Costs .

***Cash Flows from Investing Activities***

The Company used \$2.4 million and \$2.7 million of cash in investing activities during the first nine months of 2010 and 2009, respectively. Capital expenditures of \$2.4 million and \$2.7 million were primarily used to purchase computer hardware and software during the first nine months of both 2010 and 2009, respectively. We currently expect our capital investments to be between \$4.0 million and \$5.0 million for fiscal year 2010 and plan on funding less than 40% of these purchases with capital leases.

***Cash Flows from Financing Activities***

The Company used \$3.4 million and \$2.3 million of cash in financing activities during the first nine months of 2010 and 2009, respectively. Net cash outflows of \$3.4 million during the first nine months of 2010 were primarily attributable to \$1.3 million for cash dividend payments on Series B Stock, \$1.2 million of principal payments under our capital lease obligations, and \$1.0 million of cash used to acquire treasury stock. Net cash outflows of \$2.3 million during the first nine months of 2009 were primarily attributable to \$1.0 million of principal payments under our capital lease obligations, \$0.7 million of cash used to acquire treasury stock, and \$0.6 million for cash dividend payments on Series B Stock. The treasury stock acquired in each year reflects shares that were obtained to meet employee tax obligations associated with stock award vestings.

During the second quarter of 2010, the Company's Board of Directors declared a cash dividend of \$0.1785 per share on the Series B Stock, which was paid on July 1, 2010. The dividend payment for the period July 1, 2008 through December 31, 2008, payable on January 1, 2009, was suspended to conserve cash given the then-current macroeconomic uncertainties (the amount of the semiannual dividend due at that time was \$0.6 million) and remains unpaid. Under the terms of the Preferred Stock agreement, unpaid dividends are cumulative and accrue at the rate of 7% per annum. Payment of future dividends on the Series B Stock will be determined by the Company's Board of Directors based on the

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Company's outlook and macroeconomic conditions. The amount of each dividend accrual will be decreased by any conversions of the Series B Stock into Common Stock, as such conversions require us to pay accrued but unpaid dividends at the time of conversion. The Company expects to continue to acquire treasury stock between \$0.2 million and \$0.4 million during the fourth quarter of 2010 to meet employee tax obligations associated with the various stock-based compensation programs.

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**Table of Contents**

***Liquidity***

Our near-term capital resources consist of our current cash balance, together with anticipated future cash flows and financing from capital leases. Our balance of cash and cash equivalents was \$14.0 million as of September 25, 2010. In addition, our restricted cash of \$3.7 million with Bank of America (the Bank) at September 25, 2010 is available to support letters of credit issued under our credit facility (as described below) and collateral requirements for our capital lease agreements.

We anticipate that our current unrestricted cash resources, together with operating revenue and capital lease financing, should be sufficient to satisfy our short-term working capital and capital expenditure needs for the next twelve months. Management will continue to assess opportunities to maximize cash resources by actively managing our cost structure and closely monitoring the collection of our accounts receivable. If, however, our operating activities, capital expenditure requirements, or net cash needs differ materially from current expectations due to uncertainties surrounding the current capital market, credit and general economic conditions, competition, or the suspension or cancellation of a large project, then there is no assurance that we would have access to additional external capital resources on acceptable terms.

***Bank Facility***

The Company is a party to a loan agreement with the Bank. The maximum principal amount of the secured line of credit under the agreement (the Facility) is \$5.0 million as of September 25, 2010. The Facility requires the Company to maintain a minimum cash and cash equivalent balance within a secured account at the Bank. The Facility provides that the balance in the secured account cannot be less than the outstanding balance drawn on the Facility and letter of credit obligations under the Facility. Available credit under the Facility has been reduced by \$3.7 million due to letters of credit issued under the Facility to support our capital lease obligations. As a result, \$1.3 million remains available under the Facility at September 25, 2010. Loans under the Facility bear interest at the Bank's prime rate or, at the Company's election, an alternate rate of LIBOR (London InterBank Offering Rate) plus 0.75%. We did not have any borrowings or interest expense under the Facility during the first nine months of 2010 or 2009.

***Accounts Receivable Customer Concentration***

As of September 25, 2010, two clients, J. Crew Group, Inc., and Sears Holdings Management Corporation, accounted for 20% and 12% of total gross accounts receivable, respectively. Of that amount, we have collected 70% from J. Crew Group, Inc., and 64% from Sears Holdings Management Corporation through November 2, 2010, respectively. Of the total September 25, 2010 gross accounts receivable, we have collected 49% as of November 2, 2010. Because we have a high percentage of our revenue dependent on a relatively small number of clients, delayed payments by a few of our larger clients could result in a reduction of our available cash.

***Capital Lease Obligations***

Capital lease obligations as of September 25, 2010 and December 26, 2009 were \$1.6 million and \$2.7 million, respectively. We are a party to a capital lease agreement with a lease company to lease hardware and software. In 2009 and prior years, the Company was required to issue an irrevocable letter of credit for a portion of the lease amount as additional consideration for the duration of the executed lease agreement. In 2010, newly executed leases do not require an irrevocable letter of credit. We expect capital lease obligations to increase between \$1.5 million to \$2.0 million for fiscal year 2010 as we continue to expand our investment in the infrastructure for the Behavioral Analytics Service.



**Table of Contents****Contractual Obligations**

Cash will also be required for operating leases and non-cancellable purchase obligations as well as various commitments reflected as liabilities on our balance sheet as of September 25, 2010. These commitments are as follows:

(In millions)

|                                | Total          | Less Than 1 Year | 1 3 Years     | 3 5 Years     | More Than 5 Years |
|--------------------------------|----------------|------------------|---------------|---------------|-------------------|
| <b>Contractual Obligations</b> |                |                  |               |               |                   |
| Letters of credit              | \$ 3.7         | \$ 3.4           | \$ 0.3        | \$            | \$                |
| Operating leases               | 2.0            | 0.9              | 0.7           | 0.4           |                   |
| Capital leases                 | 1.9            | 1.3              | 0.6           |               |                   |
| Severance and related costs    | 0.4            | 0.1              | 0.2           | 0.1           |                   |
| Purchase obligations           | 6.6            | 6.6              |               |               |                   |
| <b>Total</b>                   | <b>\$ 14.6</b> | <b>\$ 12.3</b>   | <b>\$ 1.8</b> | <b>\$ 0.5</b> | <b>\$</b>         |

Due to the existence of the Company's net operating loss carryforward as described in Note Seven Income Taxes included in Part II Item 8 of the Form 10-K for the year ended December 26, 2009, no net contractual obligations exist as of September 25, 2010.

***Letters of Credit***

The amounts set forth in the chart above reflect standby letters of credit issued as collateral for capital leases. The terms of the Facility require us to deposit a like amount of cash into a restricted cash account at the Bank for the duration of the letter of credit commitment period. The amounts set forth in the chart above reflect the face amount of these letters of credit that expire in each period presented. To the extent these letters of credit expire without a claim being made, the cash deposited in the restricted cash account will be transferred back to an unrestricted cash account.

***Leases***

The amounts set forth in the chart above reflect future principal, interest, and executory costs of the leases entered into by the Company for technology and office equipment, as well as office and data center space. Liabilities for the principal portion of the capital lease obligations are reflected on our balance sheet as of September 25, 2010 and December 26, 2009.

***Severance and Related Costs***

Severance and related costs reflect payments the Company is required to make in future periods for severance and other related costs due to cost reduction activities in fiscal year 2010 and prior periods. Liabilities for these required payments are reflected on our balance sheet as of September 25, 2010 and December 26, 2009.

***Purchase Obligations***

Purchase obligations include \$4.9 million of commitments reflected as liabilities on our balance sheet as of September 25, 2010, as well as \$1.7 million of non-cancellable obligations to purchase goods or services in the future. Total purchase obligations were \$6.1 million as of December 26, 2009.

**Recent Accounting Pronouncements**

In October 2009, the FASB issued ASU No. 2009-13, Revenue Recognition (ASC Topic 605) Multiple-Deliverable Revenue Arrangements, a consensus of the FASB Emerging Issues Task Force. This guidance modifies the fair value requirements of ASC subtopic 605-25, Revenue Recognition-Multiple Element Arrangements, by allowing the use of the best estimate of selling price in addition to VSOE and VOE (now

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referred to as TPE) for determining the selling price of a deliverable. A vendor is now required to use its best estimate of the selling price when VSOE or TPE of the selling price cannot be determined. In addition, the residual method of allocating arrangement consideration is no longer permitted.

In October 2009, the FASB also issued ASU No. 2009-14, Software (ASC Topic 985) - Certain Revenue Arrangements That Include Software Elements, a consensus of the FASB Emerging Issues Task Force. This guidance modifies the scope of ASC subtopic 965-605, Software-Revenue Recognition, to exclude from its requirements (a) non-software components of tangible products and (b) software components of tangible products that are sold, licensed, or leased with tangible products when the software components and non-software components of the tangible product function together to deliver the tangible product's essential functionality.

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**Table of Contents**

ASU No. 2009-13 and ASU No. 2009-14 require expanded qualitative and quantitative disclosures and are effective for fiscal years beginning on or after June 15, 2010. However, companies were permitted to elect to adopt these expanded disclosures as early as interim periods ended September 30, 2009. These updates may be applied either prospectively from the beginning of the fiscal year for new or materially modified arrangements or retrospectively. We are currently evaluating the impact of adopting these updates on our consolidated financial statements.

In January 2010, the FASB issued ASU No. 2010-06, which provides new guidance related to the disclosures about transfers into and out of Levels 1 and 2 fair value classifications and separate disclosures about purchases, sales, issuances, and settlements relating to the Level 3 fair value classification. The Company's financial assets and liabilities are typically measured using Level 1 inputs. The new guidance also clarifies existing fair value disclosures about the level of disaggregation and about inputs and valuation techniques used to measure the fair value. In addition, the new guidance amends guidance on employers' disclosures about post-retirement benefit plan assets to require that disclosures be provided by classes of assets instead of by major categories of assets. The adoption of this guidance did not have an impact on our consolidated financial statements.

In February 2010, the FASB issued an amendment to the guidance on Subsequent Events, ASU No. 2010-09, which removed the requirement for an SEC registrant to disclose the date through which subsequent events are evaluated. It did not change the accounting for or disclosure of events that occur after the balance sheet date but before the financial statements are issued. This amendment was effective upon issuance. The adoption of ASU No. 2010-09 had no material effect on our consolidated financial statements.

In April 2010, the FASB issued ASU No. 2010-17, Revenue Recognition (ASC 605). This update provides guidance on the criteria that should be met for determining whether the milestone method of revenue recognition is appropriate. This guidance became effective for fiscal years, and interim periods within those years, beginning on or after June 15, 2010. We are currently evaluating the impact of adopting these updates on our consolidated financial statements.

In July 2010, the FASB issued ASU No. 2010-20, Receivables (ASC 310). This guidance relates to the credit quality of financing receivables and the allowance for credit losses. This guidance will require additional disclosures about the credit quality of financing receivables in the financial statements including, but not limited to, significant purchases and sales of financing receivables, aging information and credit quality indicators. The additional disclosures will be effective for periods ending on or after December 15, 2010. We are currently evaluating the impact of adopting these updates on our consolidated financial statements.

During 2010, the FASB issued several ASUs, ASU No. 2010-01 through ASU No. 2010-25, and during 2009, ASU No. 2009-02 through ASU No. 2009-17. Except for ASUs No. 2009-13, 2009-14, 2010-06, 2010-09, 2010-17 and 2010-20 the ASUs entail technical corrections to existing guidance or affect guidance related to specialized industries and therefore have minimal, if any, impact on the Company.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We provide solutions to clients in a number of countries, including the United States, Australia, Canada, Germany, Ireland, and the United Kingdom. For the quarters ended September 25, 2010 and September 26, 2009, 4% and 7%, respectively, of our net revenue was denominated in foreign currencies. Historically, we have not experienced material fluctuations in our results of operations due to foreign currency exchange rate changes. We do not currently engage, nor is there any plan to engage, in hedging foreign currency risk.

We also have interest rate risk with respect to changes in variable interest rates on our revolving line of credit, and our cash and cash equivalents and restricted cash. Interest on the line of credit is currently based on either the bank's prime rate, or LIBOR, which varies in accordance with prevailing market conditions. A change in interest rate impacts the interest expense on the line of credit and cash flows. This interest rate risk will not have a material impact on our financial position or results of operations.

**Table of Contents****Item 4. Controls and Procedures*****Evaluation of Disclosure Controls and Procedures***

eLoyalty maintains disclosure controls and procedures that have been designed to ensure that information related to the Company is recorded, processed, summarized, and reported on a timely basis. The Company's Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report, as required by Rule 13a-15 of the Securities Exchange Act of 1934. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the SEC.

***Changes in Internal Control over Financial Reporting***

There has been no change in eLoyalty's internal control over financial reporting that occurred during the third quarter of 2010 that has materially affected, or is reasonably likely to affect materially, eLoyalty's internal control over financial reporting.

**Part II. Other Information****Item 1. Legal Proceedings**

The Company, from time to time, has been subject to legal claims arising in connection with its business. While the results of these claims cannot be predicted with certainty, there are no asserted claims against the Company that, in the opinion of management, if adversely decided, would have a material effect on the Company's financial position, results of operations, or cash flows.

**Item 1A. Risk Factors**

There have been no material changes with respect to the factors disclosed in our Annual Report on Form 10-K for the fiscal year ended December 26, 2009.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds*****Repurchase of Equity Securities***

The following table provides information relating to the Company's purchase of shares of its Common Stock in the third quarter of 2010. All of these purchases reflect shares withheld to satisfy tax withholding obligations related to stock vestings under our stock programs. The Company has not adopted a Common Stock repurchase plan or program.

| Period                               | Total Number<br>of Shares<br>Purchased | Average<br>Price Paid<br>Per<br>Share |
|--------------------------------------|--|---------------------------------------|
| June 27, 2010 - July 25, 2010        |  | \$                                    |
| July 26, 2010 - August 25, 2010      |  | \$                                    |
| August 26, 2010 - September 25, 2010 | 34,610                                 | \$ 6.10                               |
| <b>Total</b>                         | 34,610                                 | \$ 6.10                               |

**Item 6. Exhibits**

- \*\*31.1 Certification of Kelly D. Conway under Section 302 of the Sarbanes-Oxley Act of 2002.
- \*\*31.2 Certification of William B. Noon under Section 302 of the Sarbanes-Oxley Act of 2002.
- \*\*32.1 Certification of Kelly D. Conway and William B. Noon under Section 906 of the Sarbanes-Oxley Act of 2002.

\*\* Filed herewith.

**Table of Contents**

**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, on November 4, 2010.

**eLOYALTY CORPORATION**

By /s/ WILLIAM B. NOON  
William B. Noon  
Vice President and Chief Financial Officer  
(Duly authorized signatory and  
Principal Financial and Accounting Officer)