SABA SOFTWARE INC
Form 10-Q
October 15, 2003
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended August 31, 2003

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

For the transition period from ___________ to ___________

00030221

(Commission File number)

SABA SOFTWARE, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**94-3267638**
(State or other jurisdiction	**(I.R.S. Employer**

of incorporation or organization)	**Identification No.)**
2400 Bridge Parkway,	
Redwood Shores, CA	**94065-1166**
(Address of principal executive offices)	**(Zip Code)**

(650) 696-3840

(Registrant s telephone number, including area code)

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

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

On September 30, 2003, 13,348,894 shares of the registrant s Common Stock, $.001 par value, were outstanding.

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SABA SOFTWARE, INC.

FORM 10-Q

QUARTER ENDED AUGUST 31, 2003

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PART 1: FINANCIAL INFORMATION

Item 1. Financial Statements

SABA SOFTWARE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

(unaudited)

	AUGUST 31, 2003	MAY 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 17,857	$ 17,566
Short-term investments	1,319	3,631
Accounts receivable, net	6,632	9,315
Prepaid expenses and other current assets	1,314	1,218
Total current assets	27,122	31,730
Property and equipment, net	1,925	2,385
Goodwill, net	5,288	5,288
Purchased intangible assets, net	404	542
Other assets	924	891
Total assets	$ 35,663	$ 40,836
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 1,380	$ 1,713
Accrued expenses	8,081	6,527
Deferred revenue	7,310	9,497
Current portion of debt and lease obligations	2,459	675
Total current liabilities	19,230	18,412
Deferred revenue	4	31
Accrued rent	2,674	2,691
Debt and lease obligations, less current portion	1,087	1,242
Total liabilities	22,995	22,376
Stockholders equity:		
Preferred stock, issuable in series: $0.001 par value; 1,250,000 authorized shares at August 31, 2003; none issued or outstanding		
Common stock: $0.001 par value; 50,000,000 authorized shares at August 31, 2003; 13,347,736 shares issued at August 31, 2003 and 13,328,680 shares issued at May 31, 2003	54	53
Additional paid-in capital	191,298	191,241

Deferred stock compensation	(15)	(45)
Treasury stock: 102,578 shares held at August 31, 2003 and at May 31, 2003, at cost	(232)	(232)
Accumulated deficit	(178,217)	(172,329)
Accumulated other comprehensive loss	(220)	(228)
Total stockholders equity	12,668	18,460
Total liabilities and stockholders equity	$ 35,663	$ 40,836

See Accompanying Notes to Condensed Consolidated Financial Statements.

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SABA SOFTWARE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except share and per share data)

(unaudited)

	THREE MONTHS ENDED AUGUST 31 ,	
	2003	**2002**
Revenues:		
License	$ 1,552	$ 7,450
Services	6,661	7,246
Total revenues	8,213	14,696
Cost of revenues:		
Cost of license	85	50
Cost of services	3,398	3,293
Amortization of acquired developed technology	97	388
Total cost of revenues	3,580	3,731
Gross profit	4,633	10,965
Operating expenses:		
Research and development	2,651	3,027
Sales and marketing	4,701	6,940
General and administrative	1,272	1,353
Amortization of deferred stock compensation and other stock charges	30	1,351
Amortization of purchased intangible assets	42	258
Settlement of litigation	1,701	
Total operating expenses	10,397	12,929
Loss from operations	(5,764)	(1,964)
Interest income (expense) and other, net	(79)	96
Loss before provision for income taxes	(5,843)	(1,868)
Provision for income taxes	(45)	(65)
Net loss	$ (5,888)	$ (1,933)
Basic and diluted net loss per share	$ (0.44)	$ (0.16)
Shares used in computing basic and diluted net loss per share	13,297	11,945

See Accompanying Notes to Condensed Consolidated Financial Statements.

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SABA SOFTWARE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Three months ended August 31, 2003	Three months ended August 31, 2002
Operating activities:		
Net loss	$ (5,888)	$ (1,933)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	473	805
Amortization of purchased intangible assets	42	258
Amortization of acquired developed technology	97	388
Amortization of deferred stock compensation	30	784
Issuance of common stock to third parties		82
Compensation expense resulting from acceleration of vesting of common stock		314
Acceleration of deferred stock compensation for options cancelled in the option exchange program		171
Changes in operating assets and liabilities:		
Accounts receivable	2,694	(879)
Prepaid expenses and other current assets	(96)	(142)
Other assets	(10)	(42)
Accounts payable	(333)	46
Accrued expenses	1,571	(1,407)
Accrued rent	(17)	(11)
Deferred revenue	(2,214)	(1,205)
Other liabilities	(34)	(12)
Net cash used in operating activities	(3,685)	(2,783)
Investing activities:		
Purchases of short-term investments		(5,168)
Proceeds from redemptions and maturities of short-term investments	2,309	5,774
Purchases of property and equipment	(13)	(132)
Net cash provided by investing activities	2,296	474
Financing activities:		
Proceeds from issuance of common stock under stock plans	58	181
Borrowings under credit facility, net of issuance costs	1,772	1,256
Repayments on borrowings under the credit facility	(124)	
Repayments on note payable	(18)	(17)
Principal payments under capital lease obligations	(8)	(396)
Collections on notes receivable from stockholders		112
Net cash provided by financing activities	1,680	1,136
Increase (decrease) in cash and cash equivalents	291	(1,173)
Cash and cash equivalents, beginning of period	17,566	9,523

Cash and cash equivalents, end of period	17,857	8,350
Short-term investments, end of period	1,319	12,008
Total cash, cash equivalents and short-term investments, end of period	$ 19,176	$ 20,358
Supplemental disclosure of non-cash transactions:		
Equipment purchased under capital lease obligations	$	$ 103

See Accompanying Notes to Condensed Consolidated Financial Statements.

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SABA SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Basis of Presentation

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

These unaudited condensed consolidated financial statements should be read in conjunction with Saba s audited consolidated financial statements included in Saba s Annual Report on Form 10-K filed with the Securities and Exchange Commission on August 29, 2003. The results of operations for the three months ended August 31, 2003 are not necessarily indicative of results for the entire fiscal year ending May 31, 2004 or for any future period.

The condensed consolidated balance sheet at May 31, 2003 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

All share and per share data included in the unaudited condensed consolidated financial statements and the notes thereto has been retroactively adjusted to reflect a one-for-four reverse split approved by Saba s stockholders in May 2003.

2. Basic and Diluted Net Loss Per Share

Basic and diluted net loss per share information for all periods is presented under the requirements of Statement of Financial Accounting Standards (SFAS) No. 128, Earnings per Share. Basic earnings per share has been computed using the weighted-average number of shares of common stock outstanding during the period, less shares that may be repurchased, and excludes any dilutive effects of options and warrants. Potentially dilutive issuances have been excluded from the computation of diluted net loss per share as their inclusion would be anti-dilutive. The calculations of basic and diluted net loss per share are as follows:

	Three months ended August 31, 2003	Three months ended August 31, 2002
	(in thousands, except per share amounts)	
Net loss	$ (5,888)	$ (1,933)

Weighted-average shares of common stock outstanding	13,342	12,112
Weighted-average shares subject to repurchase	(45)	(167)
Weighted-average shares of common stock used in computing basic and diluted net loss per share	13,297	11,945
Basic and diluted net loss per share	$ (0.44)	$ (0.16)

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3. Comprehensive Loss

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

	Three months ended August 31,	
	2003	2002
	(in thousands)	
Net loss	$ (5,888)	$ (1,933)
Foreign currency translation gain (loss)	11	(50)
Unrealized loss on investments	(3)	(4)
Comprehensive loss	$ (5,880)	$ (1,987)

4. Segment Information

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

Geographic Information

The following tables present revenue and long-lived assets information by geographic area:

	Total Revenue		Long-Lived Assets	
	Three months ended August 31,			
	2003	2002	August 31, 2003	May 31, 2003
	(in thousands)			
United States	$ 5,319	$ 12,126	$ 7,408	$ 7,970
International	2,894	2,570	209	245
Total	$ 8,213	$ 14,696	$ 7,617	$ 8,215

Major Customers

For three months ended August 31, 2003, no customer accounted for greater than 10% of revenues. For three months ended August 31, 2002, one customer accounted for greater than 10% of revenues.

5. Credit Facility

In August 2003, Saba renewed its credit facility to extend the availability of the revolving line of credit and equipment term loans through August 2004. In August 2003, Saba borrowed $1.8 million against the line of credit, which was repaid in September 2003. Saba also borrowed $46,000 in the form of an equipment term loan at an interest rate of 5.72%, which must be repaid in 36 monthly installments of principal plus interest. Borrowings under the credit facility are secured by substantially all of Saba s tangible assets.

The credit facility requires Saba to satisfy certain covenants on a monthly basis including a financial covenant related to unrestricted cash and cash equivalents, as well as a quarterly financial covenant related to profitability. As of August 31, 2003, Saba was not in compliance with the quarterly profitability covenant. In September 2003, Saba received a waiver from the bank for the non-compliance of this covenant. As of August 31, 2003, Saba believes it is probable that it will be in compliance with the financial covenants for the next twelve months or, if not, that it could obtain a waiver of this covenant. However, no assurance can be given that Saba will be in compliance with this covenant or that any waiver will be obtained in the event that Saba is not in compliance. In the event that Saba fails to comply and does not obtain a waiver, the lender may require immediate payment of all outstanding loan amounts.

6. Restructuring

During the three months ended August 31, 2003, Saba consolidated an excess facility resulting in a restructuring charge of $393,000. The restructuring charge was recorded under SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, and was classified in the statement of operations as follows: cost of revenues - $154,000, research and development - $127,000, sales and marketing - $73,000 and general and administrative - $39,000. The excess facilities charge included non-cancelable lease costs, less estimates for future sublease income, which will be paid over the estimated vacancy period through fiscal 2006.

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Saba s estimated costs to exit excess facilities are based on available commercial rates. The actual loss incurred in exiting these facilities could be different from Saba s estimates. A summary of the restructuring charges and related accruals are outlined as follows:

	Workforce Reduction Charges	Facilities Related Charges	Total
		(in thousands)	
Accrual as of May 31, 2003	$ 129	$ 880	$ 1,009
Charges		393	393
Deductions cash payments	(5)	(183)	(188)
Accrual as of August 31, 2003	$ 124	$ 1,090	$ 1,214
Estimated remaining cash expenditures	$ 124	$ 1,090	$ 1,214

7. Stock Options and Equity Instruments Exchanged for Services

Saba accounts for employee stock options using the intrinsic value method in accordance with APB Opinion No. 25, Accounting for Stock Issued to Employees while adhering to the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation and SFAS No. 148 Accounting for Stock-Based Compensation - Transition and Disclosure. The fair value of options, warrants and restricted stock issued for services rendered by non-employees or assets acquired is determined using the Black-Scholes option-pricing model. To calculate the expense or asset value, Saba uses either the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measured. The following table illustrates the effect on net loss and net loss per share had compensation cost for Saba s stock compensation plans been determined using the fair value method required by SFAS No. 123:

	Three months ended August 31,	
	2003	2002
	(in thousands, except per share amounts)	
Net loss as reported	$ (5,888)	$ (1,933)
Add: Total stock-based employee compensation expense included in net loss	30	1,268
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(3,362)	(3,402)
Adjusted net loss	$ (9,220)	$ (4,067)
Net loss per share as reported	$ (0.44)	$ (0.16)
Adjusted net loss per share	$ (0.69)	$ (0.34)

8. Recent Accounting Pronouncements

In August 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS No. 143 requires businesses to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When the liability is initially recorded, the entity capitalizes a cost by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, an entity either settles the obligation for its recorded amount or incurs a gain or loss upon settlement. Saba s adoption of SFAS No. 143 for its fiscal year beginning June 1, 2003 did not have a material effect on Saba s financial position or results of operations.

In February 2003, the FASB issued EITF No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF No. 00-21 requires revenue arrangements with multiple deliverables to be divided into separate units of accounting. If the deliverables in the arrangement meet certain criteria, arrangement consideration should be allocated among the separate units based on their relative fair values. Applicable revenue recognition criteria should be considered separately for each unit. The guidance in EITF No. 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Saba does not expect the adoption of EITF No. 00-21 to have a material effect on its financial position or results of operations.

9. Legal Matters

In November 2001, a complaint was filed in the United States District Court for the Southern District of New York against Saba, certain of its officers and directors, and certain underwriters of Saba s initial public offering. The complaint was purportedly filed on behalf of a class of certain persons who purchased Saba common stock between April 6, 2000 and December 6, 2000. The complaint alleges violations by Saba and its officers and directors of the Securities Act of 1933 in connection with certain alleged compensation arrangements entered into by the underwriters in connection with the offering. An amended complaint was filed in April 2002. Similar complaints have been filed against hundreds of other issuers that have had initial public offerings since 1998. The complaints were later consolidated into a single action. On July 16, 2003, a committee of Saba s board of directors conditionally approved a proposed partial settlement with the plaintiffs in this matter. The settlement would provide, among other things, a release of Saba and of the individual defendants for the conduct alleged in the action to be wrongful in the amended complaint. Saba would agree to undertake other responsibilities under the partial settlement, including agreeing to assign away, not assert, or release certain potential claims Saba may have against its underwriters. Any direct financial impact of the proposed settlement is expected to be borne by Saba s insurers. The committee agreed to approve the settlement subject to a number of conditions, including the participation of a substantial number of other issuer defendants in the proposed settlement, the consent of Saba s insurers to the settlement, and the completion of acceptable final settlement documentation. Furthermore, the settlement is subject to a hearing on fairness and approval by the court overseeing the initial public offering litigation.

On May 31, 2002, IP Learn, LLC (IP Learn) filed a complaint against Saba in the United States District Court for the Northern District of California. The compliant alleged that Saba infringed four U.S. patents assigned to IP Learn and asks the court for a preliminary and permanent injunction, as well as unspecified damages. IP Learn later amended the complaint to add a fifth patent to the suit. Substantially similar complaints have been filed against at least four other companies in Saba s industry. In September 2003, Saba reached an agreement with IP Learn regarding the settlement of the pending litigation. Under the terms of the settlement agreement, Saba is required to pay $1.1 million over the next nine months. In addition, Saba will issue approximately 134,000 shares of its common stock valued as of the settlement date at $576,000.

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

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

The following discussion of financial condition and results of operations should be read in conjunction with the Management s Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and the Notes thereto included in our Annual Report on Form 10-K for the year ended May 31, 2003. This discussion includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 (the Securities Act) and Section 21E of the Securities and Exchange Act of 1934 (the Exchange Act). All statements in this Quarterly Report on Form 10-Q other than statements of historical fact are forward-looking statements for purposes of these provisions, including any statements of the plans and objectives for future operations and any statement of assumptions underlying any of the foregoing. Statements that include the use of terminology such as may, will, expects, believes, plans, estimates, potential, or cont negative thereof or other comparable terminology are forward-looking statements. Forward-looking statements include, in Item 2, statements regarding an increase in operating expenses, including sales and marketing, research and development, and

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general and administrative, incurrence of non-cash expenses relating to stock compensation, amortization of purchased intangible assets and any potential goodwill impairment, growth of our operations and personnel, fluctuations in operating results from quarter to quarter, long sales cycles, possible acquisitions and strategic ventures, expansion of our sales and marketing organization, sufficiency of cash resources, credit facilities and cash flows to meet working capital, capital expense and business expansion requirements, development of new or enhanced applications and services, market risk exposure, impact of EITF No. 00-21, and the significance of Saba Enterprise Learning Suite and related services, as well as other products, for our revenues. These forward-looking statements involve risks and uncertainties, and it is important to note that our actual results could differ materially from those projected or assumed in such forward-looking statements. Among the factors that could cause actual results to differ materially are the factors detailed under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations Factors That May Impact Future Operating Results. All forward-looking statements and risk factors included in this document are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statement or risk factor.

OVERVIEW

We are a leading provider of human capital development and management solutions, which are designed to increase organizational performance through the implementation of a management system for aligning, developing and managing people. Our solutions can help large enterprises to efficiently manage regulatory compliance, increase sales and channel readiness, accelerate time-to-competency of people across the extended enterprise, increase speed of customer acquisition, shorten time-to-market of new products and increase visibility into organizational performance.

General

We commenced operations in April 1997 and, through March 1998, focused substantially all of our efforts on research activities, developing our products and building our business infrastructure. We shipped our first Saba Learning products and began to generate revenues from software license fees, implementation and consulting services fees and support fees in April 1998. We began to operate Saba Exchange in December 1999 and our application service provider (ASP) edition of Saba Learning in September 2000, and first shipped our limited release version of Saba Performance in May 2001. To date, we have not generated significant revenues from Saba Exchange, Saba Learning ASP Edition or Saba Performance.

Sources of Revenues and Revenue Recognition

To date, we have generated revenues primarily from licensing Saba Enterprise Learning Suite, and providing related services, including implementation, consulting, support, hosting and education.

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

- persuasive evidence of an agreement exists;
- delivery of the product has occurred;

- the fee is fixed or determinable; and
- collection of these fees is probable.

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

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License revenues are generally recognized on delivery if the other conditions of SOP 97-2 are satisfied. Revenues from our application service provider offering and from our hosting services are generally recognized ratably over the term of the arrangement. Support revenue is recognized ratably over the support term, typically 12 months, and revenue related to implementation, consulting, education and other services is generally recognized as the services are performed. Although we primarily provide implementation and consulting services on a time and materials basis, a significant portion of these services is provided on a fixed-fee basis. For contracts that involve significant customization and implementation or consulting services that are essential to the functionality of the software, the license and services revenues are recognized over the service delivery period using the percentage-of-completion method. We use labor hours incurred as a percentage of total expected hours as the measure of progress towards completion.

Cost of Revenues

Our cost of revenues includes cost of our license revenues and cost of our services revenues. Our cost of license revenues includes the cost of manuals and product documentation, production media, shipping costs and royalties to third parties. Our cost of services revenues includes salaries and related expenses for our professional services organization, as well as third-party hosting costs and billed expenses. Because our cost of services revenues is greater than cost of license revenues, cost of total revenues as a percentage of total revenues may fluctuate based on the mix of licenses and services sold.

Operating Expenses

Our operating expenses are classified into three general operational categories: research and development, sales and marketing, and general and administrative. In addition, our operating expenses include amortization of deferred stock compensation and other stock charges, and amortization of purchased intangible assets.

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

In connection with the granting of stock options to, and restricted stock purchases by, our employees, prior to our initial public offering, we recorded deferred stock compensation totaling approximately $38.4 million. This amount represents the difference between the exercise or purchase price, as applicable, and the deemed fair value of our common stock for financial accounting purposes on the date these stock options were granted or purchase agreements for restricted stock were signed. As of August 31, 2003, deferred stock compensation amounted to $15,000 and will result in additional charges to operations through the second quarter of fiscal 2004.

Our March 2001 acquisition of Human Performance Technologies, Inc. resulted in purchased intangible assets of $4.6 million, and our June 2001 acquisition of Ultris Inc. resulted in goodwill of $7.8 million and purchased intangible assets of $1.3 million. Purchased intangible assets consist of intellectual property, customer base and noncompetition agreements. The intangible assets are stated at cost less accumulated amortization and are being amortized on a straight-line basis over their estimated useful lives of six months to three years. Effective June 1, 2002, we adopted SFAS No. 142, Goodwill and Other Intangible Assets. As required by SFAS No. 142, we no longer amortize goodwill, but review it annually (or more frequently if impairment indicators arise) for impairment. Prior to June 1, 2002, goodwill was being amortized on a straight-line basis over its estimated useful life of three years.

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History of Losses

We have incurred significant losses and negative cash flows from operations since our inception. As of August 31, 2003, we had an accumulated deficit of $178.2 million. We have not achieved profitability and cannot be certain that we will be able to realize sufficient revenues to achieve or, if achieved, sustain profitability. We also expect to incur non-cash expenses relating to stock compensation, amortization of purchased intangible assets and any potential goodwill impairment. We need to generate higher revenues in order to achieve profitability. If we achieve profitability, we may not be able to sustain it.

We had 287 full-time employees as of August 31, 2003. To manage future growth of our operations and personnel, we must continue to invest in scalable operational systems, procedures and controls. We expect any future expansion to continue to challenge our ability to hire, train, manage and retain our employees.

Limited Operating History

We have a limited operating history that makes it difficult to forecast our future operating results. We believe that period-to-period comparisons of our operating results should not be relied upon as predictive of future performance. Our prospects must be considered in light of the risks, expenses and difficulties encountered by companies at a relatively early stage of development, particularly companies in new and rapidly evolving markets, such as human capital development and management. We may not be successful in addressing these risks and difficulties.

RESULTS OF OPERATIONS

THREE MONTHS ENDED AUGUST 31, 2003 AND 2002

Revenues

Total revenues decreased to $8.2 million for the three months ended August 31, 2003 from $14.7 million for the three months ended August 31, 2002. The decrease is primarily attributable to decreased license revenues in the United States. As a percentage of total revenues, revenues from customers outside the United States represented approximately 35% for the three months ended August 31, 2003 and 17% for the three months ended August 31, 2002. During the three months ended August 31, 2003, no customer more than 10% of our revenues. During the three months ended August 31, 2002, one customer represented more than 10% of our revenues.

License revenues decreased to $1.6 million, or 19% of total revenues, for the three months ended August 31, 2003, from $7.5 million, or 51% of total revenues, for the three months ended August 31, 2002. The decrease in the dollar amount of license revenues was primarily attributable to a decrease in new license sales. Also contributing to the decrease was a large license sale in the prior year that represented more than 10% of our total revenues.

Services revenues were $6.7 million, or 81% of total revenues, for the three months ended August 31, 2003 and $7.2 million, or 49% of total revenues, for the three months ended August 31, 2002. The decrease in dollar amount of services revenues is primarily attributable to decreased consulting revenues, which was partially offset by an increase in support revenues. The decline in consulting revenues was due to a decrease in license sales, an increase in the number of projects with shorter implementation periods and an increase in the number of implementations performed by third-party systems integrators.

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

Cost of Revenues

Total cost of revenues decreased to $3.6 million for the three months ended August 31, 2003 from $3.7 million for the three months ended August 31, 2002. The decrease is primarily attributable to a decrease in services personnel partially offset by an increase in allocated facilities expenses, which related to restructuring charges incurred during the quarter. Cost of services revenues represented 51% of services revenues for the three months ended August 31,

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2003 and 45% of services revenues for the three months ended August 31, 2002. The increase in the cost of services as a percentage of services revenues is primarily attributable to an increase in allocated facilities expenses, as well as a lower consultant utilization rate.

The cost of revenues includes amortization of acquired developed technology of $97,000 for the three months ended August 31, 2003 and $388,000 for the three months ended August 31, 2002. This amortization resulted from our March 2001 acquisition of Human Performance Technologies, Inc. and June 2001 acquisition of Ultris Inc.

Operating Expenses

Research and development. Research and development expenses decreased to $2.7 million for the three months ended August 31, 2003 from $3.0 million for the three months ended August 31, 2002. The decrease is primarily attributable to a decrease in research and development personnel in the U.S. offset by increased staffing in our lower-cost development center in India.

Sales and marketing. Sales and marketing expenses decreased to $4.7 million for the three months ended August 31, 2003 from $6.9 million for the three months ended August 31, 2002. The decrease is primarily attributable to reduced sales and marketing personnel, lower commission expense due to a decline in revenues and lower expenditures for marketing programs.

General and administrative. General and administrative expenses decreased to $1.3 million for the three months ended August 31, 2003 from $1.4 million for the three months ended August 31, 2002. The decrease is primarily attributable to a decrease in general administrative personnel. This decrease was partially offset by an increase in legal expenses.

Amortization of deferred stock compensation and other stock charges. Amortization of deferred stock compensation and other stock charges decreased to $30,000 for the three months ended August 31, 2003 from $1.4 million for the three months ended August 31, 2002. Included in the three months ended August 31, 2002 is $314,000 for compensation expense resulting from the acceleration of vesting of common stock for certain terminated employees. Also included in the three months ended August 31, 2002 is $171,000 related to the acceleration of amortization of deferred stock compensation for options that were cancelled in accordance with our voluntary stock option exchange program.

Amortization of purchased intangible assets. Amortization of purchased intangible assets decreased to $42,000 for the three months ended August 31, 2003 from $258,000 for the three months ended August 31, 2002. This amortization resulted from our March 2001 acquisition of Human Performance Technologies, Inc. and June 2001 acquisition of Ultris Inc.

Settlement of litigation. In September 2003, we reached an agreement regarding the settlement of pending patent litigation. Under the terms of the settlement agreement, we are required to pay $1.1 million over the next nine months. In addition, we will issue approximately 134,000 shares of our common stock valued as of the settlement date at $576,000.

Restructuring charges

During the three months ended August 31, 2003, we consolidated an excess facility resulting in a restructuring charge of $393,000, which was classified in the statement of operations as follows: cost of revenues - $154,000, research and development - $127,000, sales and marketing - $73,000 and general and administrative - $39,000. The excess facilities charge relates to non-cancelable lease costs, less estimates for sublease income, which will be paid over the estimated vacancy period through fiscal 2006. The annual cost of this facility was approximately $274,000. Our estimated costs to exit this facility are based on available commercial rates. The actual loss incurred could be different from our estimates.

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Interest income (expense) and other, net

Interest income (expense) and other, net consists of interest income, interest expense and other non-operating expenses. Interest income (expense) and other, was expense of $79,000 for the three months ended August 31, 2003, and income of $96,000 for the three months ended August 31, 2002. The decrease is primarily attributable to unfavorable fluctuations in foreign currency denominated receivables and a decrease in interest income due to a decline in our short-term investment balance.

Provision for income taxes

From inception through August 31, 2003, we incurred net losses for federal and state tax purposes. We recorded income tax expense of $45,000 during the three months ended August 31, 2003 compared to $65,000 during the three months ended August 31, 2002. The income tax expense consists entirely of foreign tax expense incurred as a result of local country profits.

FLUCTUATIONS OF QUARTERLY RESULTS

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

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

Other factors that could affect our quarterly operating results include those described below and under the caption Factors That May Affect Future Operating Results:

- dependence of our revenues on a small number of large orders and the average order value;
- our ability to attract new customers;
- any changes in revenue recognition policies and provisions and interpretations of these provisions;
- our ability to license additional products to current customers;
- the announcement or introduction of new products or services by us or our competitors;
- changes in the pricing of our products and services or those of our competitors;
- variability in the mix of our products and services revenues in any quarter;
- technical difficulties or service interruptions of our computer network systems or the Internet generally;
- the amount and timing of operating costs and capital expenditures relating to expansion or contraction of our business; and
- foreign currency fluctuations.

LIQUIDITY AND CAPITAL RESOURCES

Since inception, we have funded our operations primarily through the sale of equity securities, through which we have raised net proceeds of $135.8 million through August 31, 2003, equipment leases and other debt. As of August 31, 2003, we had outstanding equipment lease obligations of $69,000, debt of $3.5 million and $19.2 million of cash, cash equivalents and short-term investments.

Cash used in operating activities was $3.7 million during the three months ended August 31, 2003 and $2.8 million during the three months ended August 31, 2002. Cash used in operating activities during the three months

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ended August 31, 2003 was primarily attributable to a net loss of $5.9 million, which was partially offset by a decrease in accounts receivable of $2.7 million. Cash used in operating activities during the three months ended August 31, 2002 was primarily attributable to a net loss of $1.9 million, a decrease in accrued expenses of $1.4 million and a decrease in deferred revenue of $1.2 million, which was partially offset by depreciation and amortization of $805,000.

Cash provided by investing activities during the three months ended August 31, 2003 was primarily attributable to redemptions and maturities of short-term investments of $2.3 million. Cash provided by investing activities during the three months ended August 31, 2002 was primarily attributable to net redemptions and maturities of short-term investments of $606,000.

Cash provided by financing activities during the three months ended August 31, 2003 was primarily attributable to $1.8 million from the borrowings under our credit facility. Cash provided by financing activities during the three months ended August 31, 2002 was primarily attributable to $1.3 million from borrowings under our credit facility.

At August 31, 2003, we did not have any material commitments for capital expenses. Our principal commitments consisted of obligations under capital and operating leases, a note payable, our credit facility and the settlement of pending patent litigation entered into in September 2003. In August 2003, we renewed our credit facility to extend the availability of the revolving line of credit and equipment term loans through August 2004. In August 2003, we borrowed $1.8 million against the line of credit, which was repaid in September 2003. We also borrowed $46,000 in the form of an equipment term loan at an interest rate of 5.72%, which must be repaid in 36 monthly installments of principal plus interest.

The following table summarizes our contractual obligations at August 31, 2003 and the effect these obligations are expected to have on our liquidity and cash flows in future periods, excluding the $1.8 million repayment of the line of credit that occurred in September 2003. Of the $28.3 million in operating leases, net of sublease income, $1.1 million has been included in accrued restructuring charges as of August 31, 2003. Sublease income included in the table below amounted to $204,000 for fiscal 2004, $254,000 for fiscal 2005, $218,000 for fiscal 2006 and $30,000 for fiscal 2007.

	Total	Operating Leases	Capital Leases	Debt Obligations
Fiscal Year Ending May 31,		(in thousands)		
2004	$ 2,771	$ 2,253	$ 25	$ 493
2005	3,469	2,765	37	667
2006	3,238	2,720	7	511
2007	2,378	2,321		57
2008	2,351	2,351		
Thereafter	15,939	15,939		
	$ 30,146	$ 28,349	$ 69	$ 1,728

We currently anticipate that our available cash resources and credit facilities, combined with cash flows generated from revenues, will be sufficient to meet our presently anticipated working capital, capital expense and business expansion requirements for at least the next 12 months. However, we may be required, or could choose, to raise additional funds at any time. Our future liquidity and capital requirements will depend on numerous factors, including our future revenues, the timing and extent of spending to support product development efforts and expansion of sales and marketing and general and administrative activities, the success of our existing and new product and service offerings and competing technological and market developments. There can be no assurance that additional funding, if needed, will be available on terms acceptable to us, if at all.

CRITICAL ACCOUNTING POLICIES

Our 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 financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ materially from those estimates. We base our estimates and judgments on

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historical experience and on various other assumptions that we believe are reasonable under the circumstances. However, future events are subject to change and the best estimates and judgments routinely require adjustment. While there are a number of accounting policies, methods and estimates affecting our financial statements, areas that are particularly significant include revenue recognition policies, the allowance for doubtful accounts and the assessment of recoverability of goodwill and purchased intangible assets. Our critical accounting policies are described in the following paragraphs.

Revenue recognition. Our revenue recognition policies are described at the beginning of Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations.

Allowance for doubtful accounts. Accounts receivable are recorded net of allowance for doubtful accounts and totaled $6.6 million as of August 31, 2003. The allowance for doubtful accounts, which totaled $641,000 as of August 31, 2003, is based on our assessment of the collectibility of specific customer accounts and the aging of the accounts receivable. If there is a deterioration of a major customer s credit worthiness or actual defaults are higher than our historical experience, we may be required to increase the allowance for doubtful accounts.

Recoverability of goodwill and purchased intangible assets. Effective June 1, 2002, we adopted SFAS No. 142. As such, we ceased amortization of goodwill as of May 31, 2002. In addition, we evaluated our purchased intangible assets and determined that all such assets have determinable lives. Total amortization of goodwill prior to June 1, 2002 was $2.5 million and our remaining goodwill balance at August 31, 2003 was $5.3 million. Amortization of purchased intangible assets, including acquired developed technology, was $139,000 for the three months ended August 31, 2003 and $646,000 for the three months ended August 31, 2002. Our remaining purchased intangible asset balance was $404,000 as of August 31, 2003.

SFAS No. 142 prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment; while the second phase, if necessary, measures the impairment. We consider Saba to be a single reporting unit. Accordingly, all of our goodwill is associated with the entire company. We perform the required impairment analysis of goodwill annually, or on an interim basis if circumstances dictate. Any reduction of enterprise fair value below the amount of stockholders equity could require us to write down the value of goodwill to its fair value and record an expense for the impairment loss.

Restructuring costs. During the three months ended August 31, 2003, we consolidated an excess facility resulting in a restructuring charge of $393,000. The restructuring charge, which was recorded under SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, included non-cancelable lease costs, less estimates for future sublease income. After the current quarter s restructuring charge and payments on accruals from prior fiscal years, the total accrued restructuring charges as of August 31, 2003 was $1.2 million. This balance was comprised of $124,000 for workforce reduction charges and $1.1 million for facilities related charges. The assumptions we have made are based on the current market conditions in the various areas where we have vacant space and necessarily entail a high level of management judgment. These market conditions can fluctuate greatly due to such factors as changes in property occupancy rates and the rental prices charged for comparable properties. These changes could materially affect our accrual. If, in future periods, it is determined that we have over accrued for restructuring charges for the consolidation of facilities, the reversal of such over accrual would have a favorable impact on our results of operations in the period this was determined and would be recorded as a credit to restructuring costs. Conversely, if it is determined that our accrual is insufficient, an additional charge would have an unfavorable impact on our results of operations in the period this was determined.

RECENT ACCOUNTING PRONOUNCEMENTS

In August 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS No. 143 requires businesses to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When the liability is initially recorded, the entity capitalizes a cost by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, an entity either settles the obligation for its recorded amount or incurs a gain or loss upon settlement. Our adoption of SFAS No. 143 for our fiscal year beginning June 1, 2003 did not have a material effect on our financial position or results of operations.

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In February 2003, the FASB issued EITF No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF No. 00-21 requires revenue arrangements with multiple deliverables to be divided into separate units of accounting. If the deliverables in the arrangement meet certain criteria, arrangement consideration should be allocated among the separate units based on their relative fair values. Applicable revenue recognition criteria should be considered separately for each unit. The guidance in EITF No. 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. We do not expect the adoption of EITF No. 00-21 to have a material effect on our financial position or results of operations.

FACTORS THAT MAY IMPACT FUTURE OPERATING RESULTS

We have a limited operating history and are subject to the risks encountered by early-stage companies

We were founded in April 1997 and shipped our first products in April 1998. Because we have a limited operating history, you should consider and evaluate our operating prospects in light of the risks and uncertainties frequently encountered by early-stage companies in rapidly evolving markets. For us, these risks include:

- risks that our revenue forecasts may be incorrect because of our limited sales to date and our long sales process;
- risks associated with our dependence on Saba Learning, and related services, for substantially all of our revenues for the foreseeable future;
- risks that our new products, such as Saba Performance and Saba Content, will fail to achieve market acceptance;
- risks that our strategy of establishing Saba Exchange may not be successful;
- risks that fluctuations in our quarterly operating results will be significant relative to our revenues; and
- risks that the current economic downturn will continue to negatively impact the demand for our products and services.

These risks and other risks are described in more detail below. Our future growth will depend substantially on our ability to address these and the other risks described in this section. If we do not successfully address these risks, our business would be significantly harmed.

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

We have incurred significant losses and negative cash flows from operations since our inception. We have not achieved profitability and cannot be certain that we will realize sufficient revenues to achieve or sustain profitability. We expect to derive substantially all of our revenues for the foreseeable future from the licensing of Saba Learning and providing related services. Over the longer term, we expect to derive revenues from Saba Exchange, which is based on an evolving and unproven business model, and new products such as Saba Performance and services related to these offerings. In the future, we expect to continue to incur substantial non-cash expenses relating to the amortization of deferred compensation and purchased intangible assets that will contribute to our net losses. As of August 31, 2003, we had $404,000 of purchased intangible assets to be amortized. As a result of all of the foregoing, we expect to incur losses for the foreseeable future and will need to generate significantly higher revenues in order to achieve profitability. If we achieve profitability, we may not be able to sustain it.

Fluctuations of our results could cause our stock price to experience significant fluctuations or declines

Our operating results have varied significantly in the past and will likely fluctuate significantly in the future. We believe that quarter-to-quarter comparisons of our revenues and operating results are not necessarily meaningful and should not be relied on as indicators of future performance. Our operating expenses are based on our expectations of future revenues and are relatively fixed in the short-term. During fiscal 2004 and fiscal 2003 we took actions to reduce our operating expenses and, while we may from time to time reduce operating expenses in response to variability in our revenues, including variabilities caused by downturns in the United States and/or international economies, over the long term we generally expect to increase our operating expenses to expand our sales and marketing operations,

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fund greater levels of research and development, develop new alliances, increase our services and support capabilities and improve our operational and financial systems. If our revenues do not increase along with these expenses, our business would be seriously harmed and net losses in a given quarter would be even larger than expected. It is possible that in some future quarter our operating results may be below the expectations of public market analysts or investors, which could cause the market price of our common stock to fall.

Our quarterly revenues are especially subject to fluctuations because they depend on the sale of a small number of relatively large orders, principally orders for Saba Learning and related services. As a result, our quarterly operating results may fluctuate if we are unable to complete a sufficient number of large orders in any particular quarter. We have not fully developed our business model for Saba Exchange, including the structure and amount of the fees we intend to charge. As this business model evolves, the potential for fluctuations in our quarterly results could increase. Furthermore, our quarterly revenues may be affected significantly by changes in revenue recognition policies and procedures based on changes to, or new, applicable accounting standards and how these standards are interpreted.

Our lengthy sales cycle could cause delays in revenue growth

The period between our initial contact with a potential customer and the purchase of our products and services is often long. A customer s decision to purchase our products and services requires the commitment to increase performance through human capital development and management, involves a significant allocation of resources, and is influenced by a customer s budgetary cycles. To successfully sell our products and services, we generally must educate our potential customers regarding the use and benefits of our products and services, which can require significant time and resources. Many of our potential customers are large enterprises that generally take longer to make significant business decisions. Our typical sales cycle has been approximately 6 to 12 months. The delay or failure to complete sales in a particular quarter could reduce our revenues in that quarter. If our sales cycle unexpectedly lengthens in general or for one or more large orders, it would adversely affect the timing of our revenues. If we were to experience a delay on a large order, it could harm our ability to meet our forecasts for a given quarter.

A decline in the price of, or demand for, our main product, Saba Learning or our related services offerings would seriously harm our revenues and operating margins

To date, Saba Learning and related services have accounted for a substantial majority of our revenues. We anticipate that revenues from Saba Learning and related services will continue to constitute a substantial majority of our revenues for the foreseeable future. Consequently, a decline in the price of, or demand for, Saba Learning or failure to achieve broad market acceptance would seriously harm our business.

We are exposed to recent unfavorable economic conditions

We have seen a rapid and increasingly severe downturn in the United States economy since the first quarter of fiscal 2001 (ended August 31, 2000), which has been further stalled by terrorist attacks in September 2001 and the war in Iraq in early 2003. There can be no certainty as to the severity or duration of this downturn. Although we cannot predict the extent and timing, if any, of the impact of economic downturns in the United States on economies in other countries or geographic regions, we are seeing an economic slowdown in certain international markets in which we conduct business. If the economic conditions in the United States continue or worsen or if a global economic slowdown intensifies, the demand for our products and services may be reduced. Not only may these economic slowdowns reduce our customers and prospects budgets for our products and services, but also they may adversely affect our customers ability to pay for our products and services. Accordingly, these economic slowdowns may have a material adverse impact on our business, operating results and financial condition.

Our performance depends on a new market: human capital development and management

The market for software solutions that automate human capital development and management is relatively new and rapidly evolving. Substantially all of our revenues are attributable to the suite of products and services in this market. If this market fails to develop or develops more slowly than we expect, or if we fail to identify the challenges and risks in this new market or successfully address these risks, our business would be harmed.

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Our strategy of establishing Saba Exchange is unproven and may not be successful

We must more fully establish and enhance Saba Exchange, where organizations and learning providers can transact business and collaborate. Our success depends on a significant number of organizations implementing Saba Learning and conducting business with learning providers over the Internet through Saba Exchange. If this business strategy is flawed, or if we are unable to execute it effectively, our revenues may be seriously harmed. We began operating Saba Exchange in December 1999. Accordingly, we have limited experience developing and operating Saba Exchange. To date, only a limited number of learning providers and organizations are connected to Saba Exchange. It is possible that we, together with the organizations and learning providers who comprise this exchange, will not be able to effectively operate this exchange, both in terms of technical performance as well as commercial viability. It is possible that an insufficient number of organizations and/or learning providers will join and remain in Saba Exchange, and that we will be unable to generate significant revenues from Saba Exchange. Unless a critical mass of organizations and learning providers join Saba Exchange, our solutions may not achieve widespread market acceptance and our business would be seriously harmed. To date, we have not generated significant revenues from Saba Exchange.

If we lose key personnel or are unable to attract and retain additional qualified personnel, we may not be able to successfully manage our business and achieve our objectives

We believe our future success will depend upon our ability to retain our key management personnel. These employees are not subject to employment contracts. We may not be successful in attracting, assimilating and retaining our key employees in the future. Our future success and our ability to expand our operations will also depend in large part on our ability to attract and retain additional qualified technical, sales and marketing personnel. Competition for these types of employees is intense due to the limited number of qualified professionals and the high demand for them, particularly in the San Francisco Bay Area, where our headquarters is located. We have in the past experienced difficulty in recruiting qualified personnel. Failure to attract, assimilate and retain personnel, particularly technical, sales and marketing personnel, would have a material adverse effect on our business and potential growth. Additionally, volatility or a lack of positive performance in our stock price may adversely affect our ability to retain key employees, all of whom have been granted stock options or been sold restricted stock.

Difficulties we may encounter managing our growth could adversely affect our results of operations

We intend to grow our business significantly. To support our growth plans, we may need to expand our existing management, operational, financial and human resources, customer service and management information systems and controls. We may be unable to expand these systems and to manage our planned growth successfully, and this inability would adversely affect our business.

Intense competition in our target market could impair our ability to grow and to achieve profitability

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

- companies that market and license training, learning, performance, content, resource, talent and staffing management systems;

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

potential customers internal development efforts;

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

companies that operate Internet-based marketplaces for the sale of goods and services and could potentially decide to evolve their marketplaces to include content offerings; and

Internet portals that offer learning content, performance support tools or recruiting services.

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Because there are relatively low barriers to entry in the electronic commerce market, which comprises a portion of our business model, we expect competition from a variety of established and emerging companies

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

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

International revenues accounted for 35% of our revenues for the three months ended August 31, 2003 and 17% for the three months ended August 31, 2002. We intend to expand our international presence in the future. Conducting business outside of the United States is subject to certain risks, including:

- changes in regulatory requirements and tariffs;
- language barriers;
- difficulties in staffing and managing foreign operations;
- longer payment cycles and greater difficulty in collecting accounts receivable;
- reduced protection of intellectual property rights;
- potentially harmful tax consequences;
- fluctuating exchange rates;
- price controls and other restrictions on foreign currency;
- difficulties in obtaining import and export licenses;
- political and social unrest or disturbances;
- the burden of complying with a variety of foreign laws; and
- political or economic constraints on international trade.

We might not successfully market, sell or distribute our products and services in foreign markets, and we cannot be certain that one or more of the factors indicated above will not materially adversely affect our future international operations, and consequently, our business and future growth.

We may become subject to government regulation and legal uncertainties that could reduce demand for our products and services or increase the cost of doing business, thereby adversely affecting our financial results

We are not currently subject to direct regulation by any domestic or foreign governmental agency, other than regulations applicable to businesses generally, export control laws and laws or regulations directly applicable to Internet commerce. However, due to the increasing popularity and use of the Internet, it is possible that a number of laws and regulations may become applicable to us or may be adopted in the future with respect to the Internet covering issues such as:

user privacy;
taxation;
content;
right to access personal data;
copyrights;
distribution; and
characteristics and quality of services.

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The applicability of existing laws governing issues such as property ownership, copyrights, and other intellectual property issues, encryption, taxation, libel, export or import matters and personal privacy to the Internet is uncertain. The vast majority of these laws were adopted prior to the broad commercial use of the Internet and related technologies. As a result, they do not contemplate or address the unique issues of the Internet and related technologies. Changes to these laws, including some recently proposed changes, could create uncertainty in the Internet marketplace. Such uncertainty could reduce demand for our services or increase the cost of doing business due to increased costs of litigation or increased service delivery costs.

In addition, we could be liable for the misuse of personal information. The Federal Trade Commission, the European Union and certain state and local authorities have been investigating some Internet companies regarding their use of personal information. We could incur additional expenses if new regulations regarding the use of personal information are introduced or if these authorities choose to investigate our privacy practices.

Our market is subject to rapid technological change and, to compete, we must continually enhance our products and services

We must continue to enhance and improve the performance, functionality and reliability of our products and services. The software and electronic commerce industries are characterized by rapid technological change, changes in user requirements and preferences, frequent new product and services introductions embodying new technologies and the emergence of new industry standards and practices that could render our products and services obsolete. In the past, we have discovered that some of our customers desire additional performance and functionality not currently offered by our products. Our success will depend, in part, on our ability to both internally develop and license leading technologies to enhance our existing products and services, develop new products and services that address the increasingly sophisticated and varied needs of our customers, and respond to technological advances and emerging industry standards and practices on a cost-effective and timely basis. In addition, the development of our technology and other proprietary technology involves significant technical and business risks. We may fail to use new technologies effectively or to adapt our proprietary technology and systems to customer requirements or emerging industry standards. If we are unable to adapt to changing market conditions, customer requirements or emerging industry standards, we may not be able to increase our revenues and expand our business.

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

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

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

Products as complex as ours often contain unknown and undetected errors or performance problems. Many serious defects are frequently found during the period immediately following introduction and initial shipment of new products or enhancements to existing products. Although we attempt to resolve all errors that we believe would be considered serious by our customers before shipment to them, our products are not error-free. These errors or performance problems could result in lost revenues or delays in customer acceptance and would be detrimental to our business and reputation. As is typical in the software industry, with each release we have discovered errors in our products after introduction. We will not be able to detect and correct all errors before releasing our products commercially and these undetected errors could be significant. We cannot assure you that undetected errors or performance problems in our existing or future products will not be discovered in the future or that known errors considered minor by us will not be considered serious by our customers, resulting in a decrease in our revenues.

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

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights, particularly in the software and Internet-related industries. We could become subject to intellectual property infringement claims as the number of our competitors grows and our products and services overlap with competitive offerings. Any of these claims, even if not meritorious, could be expensive to defend and could divert management s attention from operating our company. If we become liable to third parties for infringing their intellectual property rights, we could be required to pay a substantial award of damages and to develop noninfringing technology, obtain a license or cease selling the products that contain the infringing intellectual property. We may be unable to develop noninfringing technology or obtain a license on commercially reasonable terms, if at all.

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

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

We do not have a comprehensive disaster recovery plan or back-up system, and a disaster could severely damage our operations

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

We outsource the management and maintenance of our hosted and ASP solutions to third parties and will depend upon them to provide adequate management and maintenance services

We rely on third parties to provide key components of our networks and systems. For instance, we rely on third-party Internet service providers to host Saba Exchange and Saba Enterprise Learning Suite for customers who desire to have these solutions hosted. We also rely on third-party communications service providers for the high-speed connections that link our and our Internet service providers Web servers and office systems to the Internet. Any Internet or communications systems failure or interruption could result in disruption of our service or loss or compromise of customer orders and data. These failures, especially if they are prolonged or repeated, would make our services less attractive to customers and tarnish our reputation.

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

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

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

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

Our past and future acquisitions may result in disruptions to our business if we fail to adequately integrate acquired businesses

In March 2001, we acquired Human Performance Technologies, Inc. and, in June 2001, we acquired Ultris Inc. As part of our overall business strategy, we expect to continue to acquire complementary businesses or technologies that will provide additional products or services offerings, additional industry expertise or an expanded geographic presence. These acquisitions could result in the use of significant amounts of cash, potentially dilutive issuances of equity securities, or the incurrence of debt. In addition, any acquisition may increase the risk of future write-offs for acquired in-process research and development, write-offs for the impairment of goodwill or long-lived assets, or amortization of expenses related to intangible assets, any of which could materially adversely affect our business and our operating results. For example, as of August 31, 2003, we had an aggregate of $404,000 of purchased intangible assets to be amortized as a result of the acquisition of Human Performance Technologies, Inc. and Ultris Inc. Although these two acquisitions are fully integrated, future acquisitions involve numerous risks, including:

- difficulties in the assimilation of the operations, technologies, products and personnel of the acquired company;
- the diversion of management s attention from other business concerns;
- risks of entering markets in which we have no or limited prior experience; and
- the potential loss of key employees of the acquired company.

Our stock price may fluctuate substantially

The market price for our common stock may be affected by a number of factors, including those described above and the following:

the announcement of new products and services or product and service enhancements by us or our competitors;
quarterly variations in our results of operations or those of our competitors;
changes in earnings estimates or recommendations by securities analysts that may follow our stock;

- developments in our industry; and
- general market conditions and other factors, including factors unrelated to our operating performance or the operating performance of our competitors.

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

Sales of shares eligible for future sale could cause our stock price to decline

If our stockholders sell substantial amounts of our common stock (including shares issued upon the exercise of outstanding options and warrants) in the public market, the market price of our common stock could fall. Such sales also might make it more difficult for us to sell equity or equity-related securities in the future at a time and price that we deem appropriate.

The anti-takeover provisions in our charter documents could adversely affect the rights of the holders of our common stock

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

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

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

ITEM 3. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

Our investments are made in accordance with an investment policy approved by our Board of Directors. All investments are carried at market value, which approximates cost. At August 31, 2003, all of our investments were considered available-for-sale securities and the average maturity of our investment securities was approximately one month. The weighted average interest rate of our portfolio was approximately 1.0% at August 31, 2003. Due to the nature of our cash equivalents and short-term investments, which are primarily money market funds, commercial paper, and U.S. government agency bonds, we believe that there is no material market risk exposure.

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The revolving line of credit portion of our credit facility allows us to make draws at a variable interest rate equal to the greater of 5% or the bank s Prime Rate plus 1%. In August 2003, we borrowed $1.8 million against the line of credit, which was repaid in September 2003. Therefore, only future borrowings would be affected by changes in the market interest rates.

The equipment term loan portion of our credit facility allows us to make draws at either a variable interest rate equal to the greater of the 5.5% or the bank s Prime Rate plus 1.5% or a fixed interest rate equal to the 36-month U.S. Treasury note plus 3.7%. As of August 31, 2003, we had outstanding equipment term loans of $449,000 that carry fixed interest rates ranging from 4.9% to 5.81%. Therefore, only future borrowings on the equipment term loan portion of our credit facility would be affected by changes in market interest rates.

As of August 31, 2003, we also had an outstanding term loan of $1.0 million that carried a variable interest rate based on the bank s Prime Rate plus 1.25 %. If the bank s Prime Rate were to change by 10% from its level at August 31, 2003, the impact would not be material to our financial position or results of operations.

Foreign Currency Risk

We provide our products and services to customers in the United States, Europe and elsewhere throughout the world. Sales are primarily made in U.S. Dollars, and to a lesser but increasing extent, British Pounds and Euros. As we continue to expand our operations, more of our contracts may be denominated in Australian Dollars, Canadian Dollars and Japanese Yen. A strengthening of the U.S. Dollar could make our products less competitive in foreign markets.

Our exposure to foreign exchange rate fluctuations also arises in part from the translation of the financial results of foreign subsidiaries into U.S. dollars in consolidation. As exchange rates vary, these results, when translated, may vary from expectations and adversely impact overall expected profitability.

ITEM 4. CONTROLS AND PROCEDURES

As of August 31, 2003, our management evaluated, under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of the design and operation of our disclosure controls and procedures. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in this report. Our management also evaluated, under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer, any change that occurred in our internal control over financial reporting during the fiscal quarter ended August 31, 2003. No such change materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In November 2001, a complaint was filed in the United States District Court for the Southern District of New York against us, certain of our officers and directors, and certain underwriters of our initial public offering. The complaint was purportedly filed on behalf of a class of certain persons who purchased our common stock between April 6, 2000 and December 6, 2000. The complaint alleges violations by us and our officers and directors of the Securities Act of 1933 in connection with certain alleged compensation arrangements entered into by the underwriters in connection with the offering. An amended complaint was filed in April 2002. Similar complaints have been filed against hundreds of other issuers that have had initial public offerings since 1998. The complaints were later consolidated into a single action. On July 16, 2003, a committee of our board of directors conditionally approved a proposed partial settlement with the plaintiffs in this matter. The settlement would provide, among other things, a release of us and of the individual defendants for the conduct alleged in the action to be wrongful in the amended complaint. We would agree to undertake other responsibilities under the partial settlement, including agreeing to assign away, not assert, or release certain potential claims we may have against our underwriters. Any direct financial impact of the proposed settlement is expected to be borne by our insurers. The committee agreed to approve the settlement subject to a number of conditions, including the participation of a substantial number of other issuer defendants in the proposed settlement, the consent of our insurers to the settlement, and the completion of acceptable final settlement documentation. Furthermore, the settlement is subject to a hearing on fairness and approval by the court overseeing the initial public offering litigation.

On May 31, 2002, IP Learn, LLC (IP Learn) filed a complaint against us in the United States District Court for the Northern District of California. The compliant alleged that we infringed four U.S. patents assigned to IP Learn and asks the court for a preliminary and permanent injunction, as well as unspecified damages. IP Learn later amended the complaint to add a fifth patent to the suit. Substantially similar complaints have been filed against at least four other companies in our industry. In September 2003, we reached an agreement with IP Learn regarding the settlement of the pending litigation. Under the terms of the settlement agreement, we are required to pay $1.1 million over the next nine months. In addition, we will issue approximately 134,000 shares of our common stock valued as of the settlement date at $576,000.

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

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

a. Exhibits

See Exhibit Index following the signature page.

b. Reports on Form 8-K.

None.

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SIGNATURES

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

	SABA SOFTWARE, INC.	
Dated: October 15, 2003	By:	/s/ Bobby Yazdani
		Chief Executive Officer and
		Chairman of the Board
		(Principal Executive Officer)
	By:	/s/ Ronald W. Kisling
		Chief Financial Officer (Principal
		Financial and Accounting Officer)

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EXHIBIT INDEX

Exhibit Number	Document
3.1[1]	Amended and Restated Certificate of Incorporation of the Company as effective as of April 12, 2000.
3.2	Amended and Restated Bylaws of the Company effective as of September 18, 2003.
4.1	Reference is made to Exhibits 3.1 and 3.2.
10.13	Third Loan Modification dated August 29, 2003 between Silicon Valley Bank and the Company.
31.1	Certification of Bobby Yazdani, Chief Executive Officer and Chairman of the Board, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Ronald W. Kisling, Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Bobby Yazdani, Chief Executive Officer and Chairman of the Board, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Ronald W. Kisling, Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) Incorporated by reference to Exhibit 3.2 to the Company s Registration Statement on Form S-1 (Registration No. 333-95761) previously filed with the SEC.