

ELOYALTY CORP  
Form 10-Q  
August 07, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED JUNE 28, 2008**

OR

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

Commission File Number 0-27975

**eLoyalty Corporation**

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

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

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

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

**Lake Forest, Illinois 60045**

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

**(847) 582-7000**

*(Registrant's telephone number, including area code)*

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company.

(Do not check if a smaller reporting company)

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

The number of shares of the registrant's Common Stock, \$0.01 par value per share, outstanding as of July 30, 2008 was 10,526,563.

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|  | June 28,<br>2008 | December 29,<br>2007 |
|--|------------------|----------------------|
| <b>ASSETS:</b>   |                  |                      |
| Current Assets:  |                  |                      |
| Cash and cash equivalents  | \$ 13,507        | \$ 21,412            |
| Restricted cash  | 3,655            | 2,455                |
| Receivables, (net of allowances of \$82 and \$110)   | 11,975           | 11,322               |
| Prepaid expenses   | 10,587           | 8,465                |
| Other current assets   | 1,278            | 1,074                |
| Total current assets   | 41,002           | 44,728               |
| Equipment and leasehold improvements, net  | 7,321            | 7,391                |
| Goodwill   | 2,643            | 2,643                |
| Intangibles, net   | 764              | 828                  |
| Other long-term assets   | 4,007            | 4,461                |
| Total assets   | \$ 55,737        | \$ 60,051            |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY:</b>  |                  |                      |
| Current Liabilities:   |                  |                      |
| Accounts payable   | \$ 4,720         | \$ 2,997             |
| Accrued compensation and related costs   | 4,005            | 5,555                |
| Unearned revenue   | 13,701           | 11,772               |
| Other current liabilities  | 3,866            | 3,783                |
| Total current liabilities  | 26,292           | 24,107               |
| Long-term unearned revenue   | 5,321            | 7,416                |
| Other long-term liabilities  | 2,267            | 1,625                |
| Total liabilities  | 33,880           | 33,148               |
| Redeemable Series B convertible preferred stock, \$0.01 par value; 5,000,000 shares authorized and designated; 3,631,547 and 3,745,070 shares issued and outstanding with a liquidation preference of \$19,169 and \$19,768 at June 28, 2008 and December 29, 2007, respectively | 18,521           | 19,100               |
| Stockholders Equity:   |                  |                      |
| Preferred stock, \$0.01 par value; 35,000,000 shares authorized; none issued and outstanding   |                  |                      |
| Common stock, \$0.01 par value; 50,000,000 shares authorized; 10,640,381 and 9,885,458 shares issued at June 28, 2008 and December 29, 2007; and 10,485,348 and 9,735,492 outstanding at June 28, 2008 and December 29, 2007, respectively                                       | 106              | 99                   |
| Additional paid-in capital   | 178,056          | 172,483              |
| Accumulated deficit  | (169,982)        | (158,548)            |

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|  |           |           |
|--|-----------|-----------|
| Treasury stock, at cost, 155,033 and 149,966 shares at June 28, 2008 and December 29, 2007 | (1,174)   | (2,731)   |
| Accumulated other comprehensive loss   | (3,670)   | (3,500)   |
| Total stockholders' equity   | 3,336     | 7,803     |
| Total liabilities and stockholders' equity   | \$ 55,737 | \$ 60,051 |

See accompanying notes to the Condensed Consolidated Financial Statements.

**Table of Contents****eLoyalty Corporation****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited and in thousands, except per share data)

|  | For the            |                    | For the          |                  |
|--|--------------------|--------------------|------------------|------------------|
|  | Three Months Ended | Three Months Ended | Six Months Ended | Six Months Ended |
|  | June 28,           | June 30,           | June 28,         | June 30,         |
|  | 2008               | 2007               | 2008             | 2007             |
| Revenue:   |                    |                    |                  |                  |
| Services   | \$ 18,219          | \$ 23,301          | \$ 39,571        | \$ 45,478        |
| Product  | 3,117              | 1,356              | 4,895            | 5,763            |
| Revenue before reimbursed expenses (net revenue)                               | 21,336             | 24,657             | 44,466           | 51,241           |
| Reimbursed expenses  | 808                | 1,313              | 1,546            | 2,651            |
| Total revenue  | 22,144             | 25,970             | 46,012           | 53,892           |
| Operating expenses:  |                    |                    |                  |                  |
| Cost of services   | 13,576             | 15,224             | 26,925           | 29,961           |
| Cost of product  | 2,423              | 918                | 3,824            | 4,432            |
| Cost of revenue before reimbursed expenses                                     | 15,999             | 16,142             | 30,749           | 34,393           |
| Reimbursed expenses  | 808                | 1,313              | 1,546            | 2,651            |
| Total cost of revenue, exclusive of depreciation and amortization shown below: | 16,807             | 17,455             | 32,295           | 37,044           |
| Selling, general and administrative  | 11,234             | 12,089             | 22,677           | 24,527           |
| Severance and related costs  | 283                |                    | 452              |                  |
| Depreciation and amortization  | 1,092              | 948                | 2,055            | 1,721            |
| Total operating expenses   | 29,416             | 30,492             | 57,479           | 63,292           |
| Operating loss   | (7,272)            | (4,522)            | (11,467)         | (9,400)          |
| Interest and other income (expense), net                                       | 4                  | 591                | 82               | 918              |
| Loss before income taxes   | (7,268)            | (3,931)            | (11,385)         | (8,482)          |
| Income tax provision   | (16)               | (6)                | (49)             | (2)              |
| Net loss   | (7,284)            | (3,937)            | (11,434)         | (8,484)          |
| Dividends related to Series B preferred stock                                  | (325)              | (363)              | (649)            | (729)            |
| Net loss available to common stockholders                                      | \$ (7,609)         | \$ (4,300)         | \$ (12,083)      | \$ (9,213)       |
| Basic net loss per common share  | \$ (0.80)          | \$ (0.52)          | \$ (1.31)        | \$ (1.13)        |
| Diluted net loss per common share  | \$ (0.80)          | \$ (0.52)          | \$ (1.31)        | \$ (1.13)        |
| Shares used to calculate basic net loss per share                              | 9,454              | 8,203              | 9,258            | 8,119            |
| Shares used to calculate diluted net loss per share                            | 9,454              | 8,203              | 9,258            | 8,119            |

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Stock-based compensation, primarily restricted stock, included in individual line items above:

|                                     |          |        |          |        |
|-------------------------------------|----------|--------|----------|--------|
| Cost of services                    | \$ 1,640 | \$ 260 | \$ 2,000 | \$ 556 |
| Selling, general and administrative | 3,346    | 2,195  | 6,768    | 5,506  |
| Severance and related costs         |          |        | 45       |        |

See accompanying notes to the Condensed Consolidated Financial Statements.

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

|   | <b>For the</b>          |                  |
|---|-------------------------|------------------|
|   | <b>Six Months Ended</b> |                  |
|   | <b>June 28,</b>         | <b>June 30,</b>  |
|   | <b>2008</b>             | <b>2007</b>      |
| <b>Cash Flows from Operating Activities:</b>  |                         |                  |
| Net loss  | \$ (11,434)             | \$ (8,484)       |
| Adjustments to reconcile net loss to net cash (used in) provided by operating activities: |                         |                  |
| Depreciation and amortization   | 2,055                   | 1,721            |
| Stock-based compensation  | 8,813                   | 6,062            |
| Provision for uncollectible amounts   | (10)                    | 152              |
| Changes in assets and liabilities:  |                         |                  |
| Receivables   | (647)                   | (1,492)          |
| Prepaid expenses  | (1,099)                 | (3,720)          |
| Other assets  | (343)                   | 635              |
| Accounts payable  | 1,706                   | 2,049            |
| Accrued compensation and related costs  | (1,386)                 | 722              |
| Unearned revenue  | (209)                   | 6,765            |
| Other liabilities   | (488)                   | (693)            |
| <b>Net cash (used in) provided by operating activities</b>                                | <b>(3,042)</b>          | <b>3,717</b>     |
| <b>Cash Flows from Investing Activities:</b>  |                         |                  |
| Capital expenditures and other  | (435)                   | (2,191)          |
| <b>Net cash used in investing activities</b>  | <b>(435)</b>            | <b>(2,191)</b>   |
| <b>Cash Flows from Financing Activities:</b>  |                         |                  |
| Acquisition of treasury stock   | (2,459)                 | (2,307)          |
| Increase in restricted cash   | (1,200)                 | (14)             |
| Payment of Series B dividends   | (669)                   | (737)            |
| Proceeds from stock compensation and employee stock purchase plans                        | 211                     | 214              |
| Principal payments under capital lease obligations  | (332)                   |                  |
| Other   |                         | 24               |
| <b>Net cash used in financing activities</b>  | <b>(4,449)</b>          | <b>(2,820)</b>   |
| <b>Effect of exchange rate changes on cash and cash equivalents</b>                       | <b>21</b>               | <b>(164)</b>     |
| Decrease in cash and cash equivalents   | (7,905)                 | (1,458)          |
| Cash and cash equivalents, beginning of period  | 21,412                  | 31,645           |
| <b>Cash and cash equivalents, end of period</b>   | <b>\$ 13,507</b>        | <b>\$ 30,187</b> |
| <b>Non-Cash Investing and Financing Transactions:</b>                                     |                         |                  |
| Capital lease obligations incurred  | \$ 1,487                | \$               |
| Capital equipment purchased on credit   | 1,487                   |                  |
| Change in net unrealized security gain  | (142)                   |                  |



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Supplemental Disclosures of Cash Flow Information:

|                                     |    |          |
|-------------------------------------|----|----------|
| Cash refunded for income taxes, net | \$ | \$ 1,155 |
| Interest paid                       |    | (241)    |

See accompanying notes to the Condensed Consolidated Financial Statements.

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**eLoyalty Corporation**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note One General**

In the opinion of management, the accompanying unaudited condensed consolidated financial statements of eLoyalty Corporation ( we , eLoyalty or the Company ) include all normal and recurring adjustments necessary for a fair presentation of our condensed consolidated financial position as of June 28, 2008 and December 29, 2007, the condensed consolidated results of our operations for the three months and six months ended June 28, 2008 and June 30, 2007 and our condensed consolidated cash flows for the six months ended June 28, 2008 and June 30, 2007, and are in conformity with Securities and Exchange Commission ( SEC ) Rule 10-01 of Regulation S-X.

The results of operations for any interim period are not necessarily indicative of the results for the full year. The accompanying financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto in our Annual Report on Form 10-K for the fiscal year ended December 29, 2007.

**Note Two Revenue Recognition**

***Behavioral Analytics Business Unit***

***Behavioral Analytics Service Line***

Consulting services revenue included in the Behavioral Analytics Service Line primarily consists of fees charged to our clients to perform Behavioral Analytics assessments. These assessments are generally performed for our clients on a fixed fee basis. Revenue is recognized as the services are performed with performance generally assessed on the ratio of actual hours incurred to date compared to the total estimated hours over the entire contract.

Managed services revenue included in the Behavioral Analytics Service Line consists of planning, deployment, training, and subscription fees. The planning, deployment and training fees, which are considered to be installation fees, related to the long-term subscription contract are deferred until the installation is complete and are then recognized over the term of the applicable subscription contract. The terms of these subscription contracts generally range from three to five years. As of June 28, 2008 and December 29, 2007, deferred revenue totaled \$6.1 million and \$5.4 million, respectively. Installation costs incurred are deferred up to an amount not to exceed the amount of deferred installation revenue and additional amounts that are recoverable based on the contractual arrangement. Such costs are amortized over the term of the subscription contract. Costs in excess of the foregoing revenue amount are expensed in the period incurred. As of June 28, 2008 and December 29, 2007, the Company had deferred costs totaling \$4.4 million and \$3.5 million, respectively.

Revenue associated with the Behavioral Analytics subscription fees are based on a number of factors such as the number of customer service representatives accessing the system and/or hours of calls analyzed during the specific month, and are recognized as the service is performed for the client.

**Marketing Managed Services**

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

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***Integrated Contact Solution/CRM Business Unit***

**Integrated Contact Solutions Service Line**

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

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

For fixed price Managed services contracts where the Company provides support for third-party software and hardware, revenue is recorded at the gross amount of the sale because the contracts satisfy the requirements for gross reporting under Emerging Issues Task Force ( EITF ) 99-19 Reporting Revenue Gross as a Principal versus Net as an Agent . If the contract does not meet the requirements for gross reporting under EITF 99-19, Managed services revenue is recorded at the net amount of the sale.

Revenue from the sale of Product, which consists primarily of third-party software and hardware resold by the Company, is generally recorded at the gross amount of the sale because the contracts satisfy the requirements for Gross reporting under EITF 99-19. Software revenue is recognized in accordance with Statement of Position ( SOP ) 97-2 Software Revenue Recognition .

Within the Integrated Contact Solutions Service Line, Consulting services, Managed services and the resale of Product may be sold and delivered together. In arrangements that include the resale of software, SOP 97-2 requires determination of vendor specific objective evidence ( VSOE ) for each of the individual elements. If VSOE does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement is deferred until all elements of the arrangement without VSOE have been delivered to the client. If the remaining undelivered elements are post contract support ( PCS ) or other deliverables with similar attribution periods, the arrangement revenue is recognized ratably over the remaining service period. Revenue of \$1.0 million and \$1.5 million has been deferred as of June 28, 2008 and December 29, 2007, respectively, due to the lack of VSOE for elements within these arrangements. This revenue will be recognized when the elements without VSOE are delivered to the client or will be recognized ratably over the remaining service period.

**Traditional CRM Service Line**

Consulting services revenue included in the Company s traditional Customer Relationship Management ( CRM ) Service Line consists of operational consulting and integrating or building a system for the client. These services are provided to the client on a time and materials or fixed fee basis. For the integration or building of a system, the Company recognizes revenue as the services are performed with performance generally assessed on the ratio of hours incurred to date compared to the total estimated hours over the entire contract. For all other consulting services, we recognize revenue as the services are performed for the client.

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

In accordance with EITF 00-21 Revenue Arrangements with Multiple Elements, arrangements containing multiple services are segmented into separate elements when the services represent separate earning processes. Revenue related to contracts with

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multiple elements is allocated based on the fair value of the element and is recognized in accordance with our accounting principles for each element, as described above. If the fair value for each element cannot be established, revenue is deferred until all elements have been delivered to the client. If PCS or similar services are the only remaining activity without established fair value, the revenue is recognized ratably over the service period. Each of our Service Lines may have arrangements that could be reviewed in accordance with EITF 00-21.

Reimbursed expenses revenue includes billable costs related to travel and other out-of-pocket expenses incurred while performing services for our clients. The charge for third-party product and support may be included within this category if the transaction does not satisfy the requirements for gross reporting under EITF 99-19 and the net revenue is recognized as Product or Managed services revenue. An equivalent amount of reimbursable expenses is included in Cost of revenue.

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

**Note Three Stock-Based Compensation*****Stock-Based Plans***

The Company issues stock awards under two stock incentive plans: the eLoyalty Corporation 1999 Stock Incentive Plan (the 1999 Plan ) and the eLoyalty Corporation 2000 Stock Incentive Plan (the 2000 Plan ). Under the 1999 Plan and the 2000 Plan, awards of restricted stock or bonus (installment) stock, salary replacement, stock options, stock appreciation rights and performance shares may be granted to directors, officers, employees, consultants, independent contractors and agents of the Company and its subsidiaries. Awards granted under the 1999 Plan and 2000 Plan are made at the discretion of the Compensation Committee of the Company s Board of Directors. If shares or options awarded under the 1999 Plan and the 2000 Plan are not issued due to cancellation of unvested or unexercised options or shares, then those options or shares again become available for issuance under the plans. Under the 1999 Plan, on the first day of each fiscal year, the aggregate number of shares available for issuance under the 1999 Plan is automatically increased by an amount equal to 5% of the total number of shares of common stock that are outstanding. Under the 2000 Plan, the Company originally reserved 280,000 shares of the Company common stock for issuance. At the 2008 Annual Meeting of Stockholders, stockholders approved the amendment and restatement of the eLoyalty Corporation 1999 Stock Incentive Plan to increase the number of shares available for issuance under the Plan by 1,500,000. As of June 28, 2008, there were a total of 1,016,275 shares available for future grants under the 1999 Plan, 2000 Plan and from treasury stock.

Stock compensation expense was \$5.0 million and \$2.5 million for the three months ended June 28, 2008 and June 30, 2007, and \$8.8 million and \$6.1 million for the six months ended June 28, 2008 and June 30, 2007, respectively. The Company recognizes stock-based compensation under Statement of Financial Accounting Standards ( SFAS ) No. 123R Shared-Based Payment . The Company recognizes stock compensation expense on a straight-line basis over the vesting period. The Company has established its forfeiture rate based on historical experience. The Company did not recognize the windfall tax benefit related to the excess tax deduction because we currently do not anticipate realizing the tax savings associated with this deduction. The amount of this excess tax deduction was \$0 and \$1.6 million for the three months ended June 28, 2008 and June 30, 2007, and \$0 and \$3.1 million for the six months ended June 28, 2008 and June 30, 2007, respectively.

***Restricted Stock***

Restricted stock awards are shares of eLoyalty common stock granted to an individual. During the restriction period, the holder of granted restricted stock receives all of the benefits of ownership (right to dividends, voting rights, etc.), other than the right to sell or otherwise transfer any interest in the stock. Installment stock awards are grants to an individual of a contractual right to receive future shares of eLoyalty common stock in specified amounts on specified vesting dates, subject to the individual remaining an eLoyalty employee on the specified vesting dates.

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Restricted and installment stock award activity was as follows for the six months ended June 28, 2008:

|  | Shares    | Weighted Average<br>Price |
|--|-----------|---------------------------|
| Nonvested balance at December 29, 2007 | 992,503   | \$ 12.80                  |
| Granted                                | 1,018,897 | \$ 9.21                   |
| Vested                                 | (514,073) | \$ 9.30                   |
| Forfeited                              | (132,818) | \$ 15.19                  |
| Nonvested balance at June 28, 2008     | 1,364,509 | \$ 11.19                  |

| (In millions)  | For the                                |                  | For the                              |                  |
|--|--|------------------|--------------------------------------|------------------|
|  | Three Months Ended<br>June 28,<br>2008 | June 30,<br>2007 | Six Months Ended<br>June 28,<br>2008 | June 30,<br>2007 |
| Total fair value of restricted and installment stock awards vested | \$ 2.2                                 | \$ 2.9           | \$ 4.7                               | \$ 7.2           |

As of June 28, 2008, there remains \$12.3 million of unrecognized compensation expense related to restricted and installment stock awards. These costs are expected to be recognized over a weighted average period of 2.6 years.

**Stock Options**

Stock option awards may be in the form of incentive or non-qualified options. Stock options are granted with an exercise price per share equal to the fair market value of a share of the Company common stock on the date of grant and have a maximum term of 10 years. The stock option terms are set by the Compensation Committee and generally become exercisable over a period of four years. The vesting can begin in equal monthly or quarterly increments over the vesting period. The Company recognized compensation expense related to option awards of \$0.2 million and \$0.2 million, respectively, for the three months ended June 28, 2008 and June 30, 2007, and \$0.5 million and \$0.4 million for the six months ended June 28, 2008 and June 30, 2007, respectively.

In addition, the 1999 Plan provides that each non-employee director, upon commencing service, shall receive a non-qualified stock option to purchase 50,000 shares of the Company common stock that vests ratably over a period of 48 months. The day after the annual stockholders meeting, each non-employee director is granted an additional non-qualified stock option to purchase 5,000 shares of the Company common stock. Stock options granted to non-employee directors have an exercise price per share equal to the fair market value of a share of the Company common stock on the grant date and are exercisable for up to 10 years.

During the first quarter of 2008, a total of 195,000 options were granted to five of the Company's officers, vesting 25% after a one year period with the balance of the shares vesting in 12 equal quarterly installments, with a maximum term of 10 years. The exercise price per share was \$10.54, the closing price of a share of eLoyalty common stock on February 19, 2008. During the first quarter of 2007, a total of 200,000 options, vesting in 16 equal quarterly installments were granted to four of the Company's officers, with a maximum term of 10 years. The exercise price per share was \$21.95, the closing price of a share of eLoyalty common stock on February 20, 2007.

During the second quarter of 2008, a total of 25,000 options were granted to non-employee directors. Each of the five non-employee directors received 5,000 options which will vest 25% on February 28, 2009, and the balance will vest quarterly over the following three years, with a maximum term of 10 years. The exercise price per share was \$6.60, the closing price of a share of eLoyalty common stock on May 16, 2008.

During the second quarter of 2007, a total of 25,000 options were granted to non-employee directors. On May 17, 2007, the newly appointed non-employee director was granted a non-qualified stock option to purchase 5,000 options of eLoyalty common stock, vesting ratably over 48 months, with a maximum term of 10 years. The exercise price per share was \$23.35, the closing price of a share of eLoyalty common stock on May 17, 2007. On May 18, 2007, a total of 20,000 options were granted to non-employee directors with each of the four non-employee directors receiving 5,000 options, vesting ratably over 12 months, with a maximum term of 10 years. The exercise price per share was \$23.38, the closing price of a share of eLoyalty common stock on May 18, 2007.



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Option activity was as follows for the six months ended June 28, 2008:

|  | Options  | Weighted<br>Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life (Years) | Weighted<br>Average<br>Fair Value<br>of Option<br>Grants |
|--|----------|---------------------------------------|---|--|
| Outstanding as of December 29, 2007                        | 744,163  | \$ 22.45                              | 6.2   |  |
| Granted  | 220,000  | \$ 10.09                              |   | \$ 5.67  |
| Exercised  |          | \$                                    |   |  |
| Forfeited  | (13,706) | \$ 138.85                             |   |  |
| Outstanding as of June 28, 2008                            | 950,457  | \$ 17.91                              | 6.6   |  |
| Exercisable as of June 28, 2008                            | 562,332  | \$ 20.36                              |   |  |
| Outstanding intrinsic value at June 28, 2008 (in millions) | \$ 0.3   |                                       |   |  |
| Exercisable intrinsic value at June 28, 2008 (in millions) | \$ 0.3   |                                       |   |  |

| (In millions)                              | For the                                |                  | For the                              |                  |
|--|--|------------------|--------------------------------------|------------------|
|  | Three Months Ended<br>June 28,<br>2008 | June 30,<br>2007 | Six Months Ended<br>June 28,<br>2008 | June 30,<br>2007 |
| Total fair value of stock options vested   | \$ 0.3                                 | \$ 0.2           | \$ 0.5                               | \$ 0.4           |
| Intrinsic value of stock options exercised | \$                                     | \$               | \$                                   | \$               |
| Proceeds received from option exercises    | \$                                     | \$ 0.2           | \$                                   | \$ 0.2           |

As of June 28, 2008, there remains \$2.9 million of unrecognized compensation expense related to stock options. These costs are expected to be recognized over a weighted average period of 1.6 years.

The fair value for options granted during the six months ended June 28, 2008 and June 30, 2007, was estimated on the date of grant using a Black Scholes option-pricing model. The Company used the following assumptions:

|                          | For the          |                  |
|--------------------------|------------------|------------------|
|                          | June 28,<br>2008 | June 30,<br>2007 |
| Risk-free interest rates | 2.5% - 3.1%      | 4.7% - 4.9%      |
| Expected dividend yield  |                  |                  |
| Expected volatility      | 58% - 59%        | 55% - 57%        |
| Expected lives           | 6 years          | 5 years          |

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

**Salary Replacement Program**

The Company implemented a Salary Replacement Program in November 2006. Under the initial program, executives and Vice Presidents exchange a percentage of their salary for grants of shares of the Company's common stock. The program began December 1, 2006 and had been authorized by the Board of Directors through December 31, 2007. In October 2007, the Board of Directors approved a modification and

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extended the plan through December 31, 2008. In addition, the program was expanded to include employees at the Senior Principal and Director levels who are based in North America. The salary reduction percentages range from 10% to 30% dependent on salary levels of the impacted executives, Vice Presidents, Senior Principals and Director levels. The percentage of salary paid in stock increased for some of the more highly compensated executives and Vice Presidents. In



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February 2008, the Board of Directors modified the plan to further reduce cash salaries at the executive and Vice President level by 7.5% of gross salary in exchange for an additional 12.5% salary in the form of additional shares. The new salary reduction percentages range from 10% to 37.5% depending on salary levels of the affected executives, Vice Presidents, Senior Principals and Director levels. Subject to quarterly Compensation Committee approval, the Company will issue common stock at fair market value commensurate with terms of the program. Under the Salary Replacement Program a total of 277,524 and 42,704 shares were granted during the six months ended June 28, 2008 and June 30, 2007, respectively.

**Other Stock Compensation**

Beginning in 2008, the Company began to pay director fees, commissions and bonuses with stock. In the first six months of 2008, the Company issued 82,978 shares as stock compensation under these programs.

**Employee Stock Purchase Plan**

During the second quarter of 2007, eLoyalty's Board of Directors and stockholders approved the proposal to increase the number of shares available under the Employee Stock Purchase Plan to 500,000. eLoyalty reinstated the Plan in the third quarter of 2007. The Plan is intended to qualify as an employee stock purchase plan under section 423 of the Internal Revenue Code. Eligible employees are permitted to purchase shares of eLoyalty common stock at below-market prices. Under this Plan, the purchase period opens on the first day of the calendar quarter and ends on the last business day of each calendar quarter, a total of 12,307 shares and 23,738 shares were issued during the three months and six months ended June 28, 2008. The first purchase period opened July 1, 2007. We recorded \$28,000 and \$76,000 of expense for this program for the three months and six months ended June 28, 2008.

**Note Four Severance and Related Costs**

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

In the second quarter of 2008, the Company recorded \$0.3 million of expense primarily related to severance and related costs for the elimination of seventeen positions. For the first six months of 2008, the Company recognized pre-tax charges (including adjustments) of \$0.5 million. The \$0.5 million of expense recorded in the first six months of 2008 is primarily due to restructuring actions taken in 2008 for the elimination of seventeen positions and 2008 adjustments related to cost reduction activities for actions taken in late fiscal year 2007.

During the first six months of 2008 and 2007, the Company made cash payments of \$1.2 million and \$0.2 million related to cost reduction actions. Included in the 2007 payments were costs related to office space reductions and office closures, reserved for in fiscal years 2002 and 2001. The Company expects substantially all remaining severance and other related accruals to be paid out by the third quarter of 2008 pursuant to agreements entered into with affected employees.

The severance and related costs and their utilization for the six months ended June 28, 2008 are as follows:

| (In millions)                                      | Employee<br>Severance |
|--|-----------------------|
| <b>Balance, December 29, 2007</b>                  | <b>\$ 0.8</b>         |
| Charges  | 0.3                   |
| Adjustments charged to severance and related costs | 0.2                   |
| Charged to severance and related costs             | 0.5                   |
| Payments   | (1.2)                 |
| <b>Balance, June 28, 2008</b>                      | <b>\$ 0.1</b>         |



**Table of Contents****Note Five Current Unearned Revenue**

Current unearned revenue was \$13.7 million and \$11.8 million as of June 28, 2008 and December 29, 2007. Current unearned revenue reflects prepayment by our clients in advance of our recognition of this revenue. Payments are generally received in advance from clients that are utilizing our Behavioral Analytics Managed services and Integrated Contact Solutions Managed services. Current unearned revenue will be recognized within the next twelve months and consisted of the following:

| (In millions)                                 | June 28,<br>2008 | As of<br>December 29,<br>2007 |
|---|------------------|-------------------------------|
| Integrated Contact Solutions Managed Services | \$ 9.2           | \$ 8.5                        |
| Behavioral Analytics Managed Services         | 2.9              | 2.2                           |
| Other   | 1.6              | 1.1                           |
| Total   | \$ 13.7          | \$ 11.8                       |

**Note Six Long-Term Unearned Revenue**

Long-term unearned revenue was \$5.3 million and \$7.4 million as of June 28, 2008 and December 29, 2007. Long-term unearned revenue reflects prepayment by our clients in advance of our recognition of this revenue. Payments are generally received in advance from clients that are utilizing our Behavioral Analytics Managed services and Integrated Contact Solutions Managed services. Long-term unearned revenue reflects revenue that will be recognized beyond the next twelve months and consisted of the following:

| (In millions)                                 | June 28,<br>2008 | As of<br>December 29,<br>2007 |
|---|------------------|-------------------------------|
| Integrated Contact Solutions Managed Services | \$ 2.1           | \$ 3.7                        |
| Behavioral Analytics Managed Services         | 3.2              | 3.2                           |
| Other   |                  | 0.5                           |
| Total   | \$ 5.3           | \$ 7.4                        |

**Note Seven Comprehensive Net Loss**

Comprehensive net loss is comprised of the following:

| (In millions)                                   | For the<br>Three Months Ended |                  | For the<br>Six Months Ended |                  |
|---|-------------------------------|------------------|-----------------------------|------------------|
|   | June 28,<br>2008              | June 30,<br>2007 | June 28,<br>2008            | June 30,<br>2007 |
| Net loss  | \$ (7.3)                      | \$ (3.9)         | \$ (11.4)                   | \$ (8.5)         |
| Other comprehensive loss:                       |                               |                  |                             |                  |
| Unrealized (loss) gain on marketable securities | (0.1)                         |                  | (0.2)                       |                  |
| Effect of currency translation                  |                               | (0.2)            |                             | (0.2)            |
| Comprehensive net loss                          | \$ (7.4)                      | \$ (4.1)         | \$ (11.6)                   | \$ (8.7)         |

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The accumulated other comprehensive loss, which represents the cumulative effect of foreign currency translation adjustments and unrealized gains on marketable securities, was \$3.7 million and \$3.5 million at June 28, 2008 and December 29, 2007, respectively. The unrealized gain relates to stock of a publicly traded company, the value of which is included in Other Current Assets.

**Table of Contents****Note Eight Loss Per Share**

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

| (In millions, except share and per share data)                                 | For the                                |                  | For the                              |                  |
|--|--|------------------|--------------------------------------|------------------|
|  | Three Months Ended<br>June 28,<br>2008 | June 30,<br>2007 | Six Months Ended<br>June 28,<br>2008 | June 30,<br>2007 |
| Net loss   | \$ (7.3)                               | \$ (3.9)         | \$ (11.4)                            | \$ (8.5)         |
| Series B preferred stock dividends   | (0.3)                                  | (0.4)            | (0.7)                                | (0.7)            |
| Net loss available to common stockholders                                      | \$ (7.6)                               | \$ (4.3)         | \$ (12.1)                            | \$ (9.2)         |
| Per common share   |  |                  |                                      |                  |
| Basic loss before Series B preferred stock dividends                           | \$ (0.77)                              | \$ (0.48)        | \$ (1.24)                            | \$ (1.04)        |
| Basic net loss   | \$ (0.80)                              | \$ (0.52)        | \$ (1.31)                            | \$ (1.13)        |
| Weighted average common shares outstanding (in thousands)                      | 9,454                                  | 8,203            | 9,258                                | 8,119            |
| Currently anti-dilutive common stock equivalents <sup>(1)</sup> (in thousands) | 3,834                                  | 4,961            | 3,720                                | 4,913            |

(1) In periods in which there was a loss, the dilutive effect of common stock equivalents, which is primarily related to the 7% Series B Convertible Preferred Stock, was not included in the diluted loss per share calculation as they were antidilutive.

**Note Nine Leases****Capital Leases**

The Company acquired \$1.5 million of computer equipment and leasehold improvements using capital leases in 2008. These assets were primarily related to investments in our Behavioral Analytics Service Line. All capital leases are for a term of 3 years. The liabilities for these capital leases are included in Other current liabilities and Other long-term liabilities on the balance sheet.

The following is a schedule by year of future minimum lease payments under capital leases together with the present value of the net minimum lease payments as of June 28, 2008:

| (In millions)<br>Year              | Amount |
|------------------------------------|--------|
| 2008                               | \$ 0.6 |
| 2009                               | 1.3    |
| 2010                               | 1.4    |
| Thereafter                         |        |
| Total minimum lease payments       | \$ 3.3 |
| Less: estimated executory costs    | (0.4)  |
| Net minimum lease payments         | \$ 2.9 |
| Less: amount representing interest | (0.3)  |

|   |        |
|---|--------|
| Present value of minimum lease payments | \$ 2.6 |
|---|--------|

**Note Ten Segment Information**

Beginning in 2008 the Company operates in two business segments, Behavioral Analytics™ services and Integrated Contact Solutions/CRM, based on the criteria of Financial Accounting Standards Board ( FASB ) Statement of Financial Accounting Standards ( SFAS ) No. 131 Disclosure about Segments of an Enterprise and Related Information . These segments are consistent with the Company s management of the business and reflect its internal financial reporting structure and operating focus.

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

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

Management believes that Segment Operating Income/(Loss) Before Stock-Based Compensation, Severance and Related Costs, and Depreciation and Amortization is an appropriate measure of evaluating the operational performance of the Company's segments. However, this measure should be considered in addition to, not as a substitute for, or superior to, income from operations or other measures of financial performance prepared in accordance with General Accepted Accounting Principles. The Company does not allocate depreciation or amortization or other items below the Operating Income/(Loss) level to the business segments. Also, the Company does not track or review asset information, other than capital expenditures, by reportable segments. Prior to 2008, the Company operated in one business segment and did not track information for the two new business segments. The 2007 data is not presented because it would be impractical to obtain information for the two new business segments.

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

| (In millions)  | Quarter to Date<br>Segment Reporting at June 28, 2008 |  |           | Total    |
|--|---|--|-----------|----------|
|  | Behavioral<br>Analytics                               | Integrated<br>Contact<br>Solutions/CRM | Corporate |          |
| Revenue  |   |  |           |          |
| Services   | \$ 3.5  | \$ 14.7                                | \$        | \$ 18.2  |
| Product  |   | 3.1                                    |           | 3.1      |
| Net revenue  | 3.5   | 17.8                                   |           | 21.3     |
| Reimbursed expenses  | 0.1   | 0.7                                    |           | 0.8      |
| Total revenue  | 3.6   | 18.5                                   |           | 22.1     |
| Segment operating income/(loss) before stock-based compensation, severance and related costs and depreciation and amortization | (2.0)   | 3.8                                    | (2.7)     | (0.9)    |
| Stock-based compensation   | 1.9   | 2.4                                    | 0.7       | 5.0      |
| Severance and related costs  |   |  | 0.3       | 0.3      |
| Depreciation and amortization  |   |  | 1.1       | 1.1      |
| Operating income/(loss)  | (3.9)   | 1.4                                    | (4.8)     | (7.3)    |
| Interest and other income/(expense)  |   |  |           |          |
| Income taxes   |   |  |           |          |
| Net income/(loss)  | \$ (3.9)  | \$ 1.4                                 | \$ (4.8)  | \$ (7.3) |
| Capital investments  | \$ 0.4  | \$                                     | \$        | \$ 0.4   |

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| (In millions)  | Year to Date<br>Segment Reporting at June 28, 2008 |  |           |  | Total     |
|--|--|--|-----------|--|-----------|
|  | Behavioral<br>Analytics                            | Integrated<br>Contact<br>Solutions/CRM | Corporate |  |           |
| Revenue  |  |  |           |  |           |
| Services   | \$ 8.3   | \$ 31.3                                | \$        |  | \$ 39.6   |
| Product  |  | 4.9                                    |           |  | 4.9       |
| Net revenue  | 8.3  | 36.2                                   |           |  | 44.5      |
| Reimbursed expenses  | 0.2  | 1.3                                    |           |  | 1.5       |
| Total revenue  | 8.5  | 37.5                                   |           |  | 46.0      |
| Segment operating income/(loss) before stock-based compensation, severance and related costs and depreciation and amortization | (2.5)  | 8.3                                    | (6.0)     |  | (0.2)     |
| Stock-based compensation   | 3.6  | 3.8                                    | 1.4       |  | 8.8       |
| Severance and related costs  |  |  | 0.4       |  | 0.4       |
| Depreciation and amortization  |  |  | 2.1       |  | 2.1       |
| Operating income/(loss)  | (6.1)  | 4.5                                    | (9.9)     |  | (11.5)    |
| Interest and other income/(expense)  |  |  | 0.1       |  | 0.1       |
| Income taxes   |  |  |           |  |           |
| Net income/(loss)  | \$ (6.1)   | \$ 4.5                                 | \$ (9.8)  |  | \$ (11.4) |
| Capital investments  | \$ 1.7   | \$ 0.1                                 | \$ 0.1    |  | \$ 1.9    |

**Note Eleven Fair Value Measurements**

As discussed in Note Twelve effective January 1, 2008 the Company adopted SFAS No. 157 as it relates to financial assets and liabilities that are being measured and reported at fair value on a recurring basis. Although the adoption of SFAS No. 157 had no material effect on its consolidated financial statements, the Company is now required to provide additional disclosure as part of its financial statements. In accordance with FSP FAS 157-2, the Company deferred adoption of SFAS No. 157 as it relates to non-financial assets and liabilities measured at fair value on a non-recurring basis.

SFAS No. 157 clarifies that fair value is an exit price and also establishes a three-tier valuation hierarchy for ranking the quality and reliability of the information used to determine fair values. The first tier (Level 1) uses quoted market prices in active markets for identical assets or liabilities. Level 2 uses inputs, other than quoted market prices for identical assets or liabilities in active markets, which are observable either directly or indirectly. Level 3 uses unobservable inputs in which there are little or no market data and requires the entity to develop its own assumptions. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

The following table provides the assets and liabilities carried at fair value measured on a recurring basis as of June 28, 2008:

| (In millions)                 | Fair Value Measurements at June 28, 2008 Using |  |                                  |  |
|-------------------------------|--|--|----------------------------------|--|
|                               | Total carrying<br>at<br>June<br>28,<br>2008    | Quoted Prices in<br>Active<br>Markets<br>(Level 1) | Other<br>Observable<br>(Level 2) | Significant<br>Unobservable<br>(Level 3) |
| Available for sale securities | \$ 0.3   | \$ 0.3   | \$                               | \$                                       |

These securities are included in Other Current Assets on the Company's balance sheet.





**Table of Contents****Note Twelve Recent Accounting Pronouncements**

In May 2008, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 162 The Hierarchy of Generally Accepted Accounting Principles . SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. SFAS No. 162 becomes effective sixty days following the Securities and Exchange Commission 's approval of Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles . The Company is currently evaluating the potential impact, if any, of the adoption of FAS No. 162 on its consolidated financial statements.

In April 2008, the FASB issued FASB Staff Position No. FAS 142-3, *Determination of the Useful Life of Intangible Assets* ( FSP No. FAS 142-3 ). FSP No. FAS 142-3 requires companies estimating the useful life of a recognized intangible asset to consider their historical experience in renewing or extending similar arrangements or, in the absence of historical experience, to consider assumptions that market participants would use about renewal or extension as adjusted for SFAS No. 142 s, *Goodwill and Other Intangible Assets*, entity-specific factors. FSP No. FAS 142-3 will be effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the potential impact of adoption of FSP No. FAS 142-3 on its consolidated financial statements. However, the Company does not expect the adoption of FSP No. FAS 142-3 to have a material effect on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The company did not elect the fair value option permitted under SFAS 159 so adoption had no impact on its financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements , which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for fiscal years beginning after November 15, 2007. On February 14, 2008 the FASB issued FSP FAS No. 157-1 Application of FASB Statement No. 157 to FASB Statement 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement Under Statement 13 that amends SFAS No. 157 to exclude its application for purposes of lease classification or measurement under SFAS 13. On February 12, 2008, the FASB issued Staff Position Financial Accounting Standard (FSP FAS) No. 157-2 Effective Date of FASB Statement No. 157 that amends SFAS No. 157 to delay the effective date for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis to fiscal years beginning after November 15, 2008. The Company adopted the required provisions of SFAS No. 157-1 effective January 1, 2008 and there was no material effect on its consolidated financial statements. The company has adopted SFAS 157-2 to delay the adoption effects related to non-financial assets and does not anticipate there will be a material effect on its consolidated financial statements. See Note Eleven for additional information related to the adoption of FAS 157 related to financial assets.

**Note Thirteen Litigation and Other Contingencies**

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

The Company is a party to various agreements, including substantially all major services agreements and intellectual property licensing agreements, under which it may be obligated to indemnify the other party with respect to certain matters, including, but not limited to, indemnification against third-party claims of infringement of intellectual property rights with respect to software and

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other deliverables provided by us in the course of our engagements. These obligations may be subject to various limitations on the remedies available to the other party, including, without limitation, limits on the amounts recoverable and the time during which claims may be made and may be supported by indemnities given to the Company by applicable third parties. Payment by the Company under these indemnification clauses is generally subject to the other party making a claim that is subject to challenge by the Company and dispute resolution procedures specified in the particular agreement. Historically, the Company has not been obligated to pay any claim for indemnification under its agreements and management is not aware of future indemnification payments that it would be obligated to make.

Under its By-Laws, subject to certain exceptions, the Company has agreed to indemnify its officers and directors for certain events or occurrences while the officer or director is, or was, serving at its request in such capacity or in certain related capacities. The Company has separate indemnification agreements with each of its directors and officers that requires it, subject to certain exceptions, to indemnify them to the fullest extent authorized or permitted by its By-Laws and the Delaware General Corporation Law. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a director and officer liability insurance policy that limits its exposure and enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal. The Company has no liabilities recorded for these agreements as of June 28, 2008.

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

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

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

***Revenue Recognition***

***Behavioral Analytics Business Unit***

**Behavioral Analytics Services**

Consulting services revenue included in the Behavioral Analytics Service Line primarily consists of fees charged to our clients to perform Behavioral Analytics assessments. These assessments are generally performed for our clients on a fixed fee basis. Revenue is recognized as the services are performed with performance generally assessed on the ratio of actual hours incurred to date compared to the total estimated hours over the entire contract.

Managed services revenue included in the Behavioral Analytics Service Line consists of planning, deployment, training, and subscription fees. The planning, deployment and training fees, which are considered to be installation fees, related to the long-term subscription contract are deferred until the installation is complete and are then recognized over the term of the applicable subscription contract. The terms of these subscription contracts generally range from three to five years. As of June 28, 2008 and December 29, 2007, deferred revenue totaled \$6.1 million and \$5.4 million, respectively. Installation costs incurred are deferred up to an amount not to exceed the amount of deferred installation revenue and additional amounts that are recoverable based on the contractual arrangement. Such costs are amortized over the term of the subscription contract. Costs in excess of the foregoing revenue amount are expensed in the period incurred. As of June 28, 2008 and December 29, 2007, the Company had deferred costs totaling \$4.4 million and \$3.5 million, respectively.

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Revenue associated with the Behavioral Analytics subscription fees are based on a number of factors such as the number of customer service representatives accessing the system and/or hours of calls analyzed during the specific month, and are recognized as the service is performed for the client.

### **Marketing Managed Services**

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

### ***Integrated Contact Solution/CRM Business Unit***

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

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

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

For fixed price Managed services contracts where the Company provides support for third-party software and hardware, revenue is recorded at the gross amount of the sale because the contracts satisfy the requirements for gross reporting under Emerging Issues Task Force ( EITF ) 99-19 Reporting Revenue Gross as a Principal versus Net as an Agent . If the contract does not meet the requirements for gross reporting under EITF 99-19, Managed services revenue is recorded at the net amount of the sale.

Revenue from the sale of Product, which consists primarily of third-party software and hardware resold by the Company, is generally recorded at the gross amount of the sale because the contracts satisfy the requirements for Gross reporting under EITF 99-19. Software revenue is recognized in accordance with Statement of Position ( SOP ) 97-2 Software Revenue Recognition .

Within the Integrated Contact Solutions Service Line, Consulting services, Managed services and the resale of Product may be sold and delivered together. In arrangements that include the resale of software, SOP 97-2 requires determination of vendor specific objective evidence ( VSOE ) for each of the individual elements. If VSOE does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement is deferred until all elements of the arrangement without VSOE have been delivered to the client. If the remaining undelivered elements are post contract support ( PCS ) or other deliverables with similar attribution periods, the arrangement revenue is recognized ratably over the remaining service period. Revenue of \$1.0 million and \$1.5 million has been deferred as of June 28, 2008 and December 29, 2007, respectively, due to the lack of VSOE for elements within these arrangements. This revenue will be recognized when the elements without VSOE are delivered to the client or will be recognized ratably over the remaining service period.

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### **Traditional CRM Service Line**

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

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

In accordance with EITF 00-21 Revenue Arrangements with Multiple Elements, arrangements containing multiple services are segmented into separate elements when the services represent separate earning processes. Revenue related to contracts with multiple elements is allocated based on the fair value of the element and is recognized in accordance with our accounting principles for each element, as described above. If the fair value for each element cannot be established, revenue is deferred until all elements have been delivered to the client. If PCS or similar services are the only remaining activity without established fair value, the revenue is recognized ratably over the service period. Each of our Service Lines may have arrangements that could be reviewed in accordance with EITF 00-21.

Reimbursed expenses revenue includes billable costs related to travel and other out-of-pocket expenses incurred while performing services for our clients. The cost of third-party product and support may be included within this category if the transaction does not satisfy the requirements for gross reporting under EITF 99-19 and the net revenue is recognized as Product or Managed services revenue. An equivalent amount of reimbursable expenses is included in Cost of revenue.

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

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

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

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

We adopted the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123R, Share-Based Payment, beginning January 1, 2006, using the modified prospective method. The adoption of SFAS No. 123R did not have a material impact on our financial position or results of operations. SFAS No. 123R requires entities to recognize compensation expense from all share-based payment transactions in the financial statements after the adoption date. SFAS No. 123R establishes fair value as the measurement objective in accounting for share-based payment arrangements and requires all companies to apply a fair-value-based measurement method in accounting for all share-based payment transactions with employees. Historical information is the primary basis for the selection of expected life, expected volatility, expected dividend yield assumptions and anticipated forfeiture rates. The risk-free interest rate is selected based on the yields from U.S. Treasury Strips with a remaining term equal to the expected term of the options being valued. Under the modified prospective method, financial statements for periods prior to the date of adoption are not adjusted for the change in accounting.

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

We recorded accruals for severance and related costs associated with our cost reduction efforts undertaken during fiscal years 2001 through 2008. The portion of the accruals relating to employee severance represents contractual severance for identified

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employees and generally is not subject to a significant revision. Prior to 2007, a portion of the accruals related to office space reductions, office closures and associated contractual lease obligations that were based in part on assumptions and estimates of the timing and amount of sublease rentals affected by overall economic and local market conditions. To the extent estimates of the success of our sublease efforts changed, adjustments increasing or decreasing the related accruals have been recognized. No adjustments related to sublease efforts were made in the first six months of 2008.

### ***Income Taxes***

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

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

For a description of the Company's other significant accounting policies, see Note Two Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements included in our Annual Report filed on Form 10-K for the year ended December 29, 2007.

### **Forward-Looking Statements**

This Quarterly Report on Form 10-Q (this Form 10-Q) contains forward-looking statements that are based on current management expectations, forecasts and assumptions. These include, without limitation, statements containing the words believes, anticipates, estimates, expects, plans, intends, projects, future, should, could, seeks, target, may, will continue to, predicts, forecasts, potential, guidance, expressions, references to plans, strategies, objectives and anticipated future performance and other statements that are not strictly historical in nature. These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or implied by the forward-looking statements. Such risks, uncertainties and other factors that might cause such a difference include, without limitation, those noted under Risk Factors included in Part I Item 1A of Form 10-K for the year ended December 29, 2007, as well as the following:

Uncertainties associated with the attraction of new clients, the continuation of existing and new engagements with existing clients and the timing of related client commitments; reliance on a relatively small number of clients for a significant percentage of our revenue;

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

Variations in sales of products in connection with client engagements;

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

Management of growth and development and introduction of new service offerings, including Behavioral Analytics™ services;

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

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

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

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

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

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

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

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

Future legislative or regulatory actions relating to the information technology or information technology service industries, including those relating to data privacy;

Changes by the Financial Accounting Standards Board or the Securities and Exchange Commission ( SEC ) of authoritative accounting principles generally accepted in the United States of America or policies or changes in the application or interpretation of those rules or regulations;

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

General economic, business and market conditions;

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

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

## **Background**

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

The Company is focused on growing and developing its business through two primary Business Units, Behavioral Analytics services and Integrated Contact Solutions/CRM. Through these Business Units, the Company generates three types of revenue: (1) Consulting services revenue, which is generally project-based and sold on a time and materials or fixed-fee basis; (2) Managed services revenue, which is recurring,



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annuity revenue from long-term (generally one to five year) contracts; and (3) Product revenue, which is generated through the resale of third-party software and hardware. The chart below shows the relationship between these business units and the types of revenue generated from each.

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|   | <b>Consulting Services</b>  | <b>Managed Services</b>  | <b>Product</b>  |
|---|---|--|---|
| <b>Behavioral Analytics</b>                           | <b>Revenue</b><br>Assessments and follow-on consulting revenue                      | <b>Revenue</b><br>Subscription and amortized deployment revenue, marketing application hosting and email fulfillment revenue | <b>Revenue</b><br>None  |
| <b>Business Unit Integrated Contact Solutions/CRM</b> | Implementation and follow-on consulting revenue, traditional CRM consulting revenue | Contact Center monitoring and support revenue, remote application support revenue  | Hardware and software resale revenue, primarily products from Cisco Systems |

**Business Unit**

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

***Behavioral Analytics Business Unit***

**Behavioral Analytics™ Service Line**

eLoyalty pioneered this solution, which improves the reliability of call recording and applies human behavioral modeling to analyze and improve customer interactions. Using its Behavioral Analytics services, eLoyalty can help clients:

Automatically measure customer satisfaction and agent performance on every call;

Identify and understand customer personality;

Improve rapport between agent and customer;

Reduce call handle times while improving customer satisfaction;

Identify opportunities to improve self-service applications;

Improve cross-sell and up-sell success rates; and

Improve the efficiency and effectiveness of collection efforts.

eLoyalty has designed a scalable application platform to enable the Company to implement and operate Behavioral Analytics services for its clients. Behavioral Analytics services are primarily hosted by eLoyalty and delivered as a subscription service. Consulting Services revenue consists of assessment services and Managed Services revenue consists of deployment and subscription services.

**Marketing Managed Services**

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



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### ***Integrated Contact Solutions/CRM Business Unit***

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

The Company's Integrated Contact Solutions Service Line focuses on helping clients realize the benefits of transitioning their contact centers to a single network infrastructure from the traditional two-network (voice network and separate data network) model. These benefits include cost savings, remote agent flexibility and application enhancements. The Company has developed a set of tools and methodologies to help clients financially model, plan migration paths, and configure, integrate and support Converged Internet Protocol (IP) network solutions within their contact center environments. Also included in this Service Line is managed services revenue consisting of contact center support and monitoring services.

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

The Company's Traditional CRM Service Line focuses on operational consulting and integrating or building a system for the client. Also included in this Service Line is managed services revenue consisting of remote application support.

#### **Types of Revenue**

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

#### ***Consulting Services***

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

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

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

Designing integrated architectures for enterprise-wide contact center environments. Our architects optimize cost efficiency with reliability, functionality, and effectiveness as we help our clients migrate to state-of-the-art infrastructure.

Implementing the functional, technical, and human performance aspects of CRM solutions. This often involves the integration of a variety of infrastructure and application hardware and software from third-party vendors.

#### ***Managed Services***

Growth in Managed services revenue is primarily driven by Behavioral Analytics services and Integrated Contact Solutions engagements. These Managed services consist of the following:

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Behavioral Analytics Managed Services include the deployment and ongoing operation of our proprietary Behavioral Analytics services. Based on each client's business requirements, the applications are configured and integrated into the client's environment and then deployed in either a remote-hosted or, in some cases, on-premise hosted environment. The service is provided on a subscription basis and the contract duration generally is three to five years. The fees and costs related to the initial deployment are deferred and amortized over the life of the contract.

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

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

### ***Product***

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

### **Business Outlook**

We continue to be encouraged by the strength of our new business pipeline, and the improvement in our revenue mix that is being driven by our Behavioral Analytics™ and Integrated Contact Solutions Service Lines.

In the second half of 2008, we expect moderate growth in our Managed services revenue, compared to the first half of 2008, as a result of higher Integrated Contact Solutions support and maintenance revenue and substantially higher Behavioral Analytics™ services deployment and subscription revenue. Other sources of Managed services revenue, such as remote application maintenance and support and Marketing Managed Services, are expected to continue to decline in the second half of 2008. Overall, 2008 Managed Services revenue is expected to be moderately higher than in 2007.

Consulting services revenue will decline moderately in the second half of 2008, compared to the first half of 2008, due to significant decline in demand for our Traditional CRM consulting services. The second half of 2008 revenue decline should be partially offset by moderate growth in Consulting revenue from our Integrated Contact Solutions Service Line and substantial growth in Consulting services revenue from our Behavioral Analytics™ Service Line. Overall, 2008 Consulting services revenue is expected to decrease considerably in comparison to 2007.

Product revenue should experience significant growth in the last half and for the full year of 2008, compared to the first half of 2008 and fiscal year 2007.

We continue to invest in the personnel required to sell and manage complex, long-term relationships and in the resources required to develop, deliver and support our innovative Behavioral Analytics™ services. These investments may affect our profitability and cash resources in 2008, but we believe they are required to continue to build our Managed services backlog and to maintain and strengthen our competitive advantage. As a result, management has assessed and will continue to assess all areas of the cost structure to identify opportunities to maximize profitability and cash resources. For example, in the first quarter of 2008 the Salary Replacement Program was amended to increase the percentage of total compensation that is paid in stock to Vice Presidents and we also continue to pay commissions earned in 2008 with stock.

### ***Managed Services Backlog***

As a result of the strategic and long-term nature of Managed services revenue, we believe it is appropriate to monitor the level of backlog associated with these agreements. The Managed services backlog was \$69.5 million as of June 28, 2008 and \$72.8 million as of December 29, 2007 largely because Managed services revenue exceeded Managed services bookings during the first six months of

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2008. The Company anticipates an increase to the Managed services backlog for 2008. Of the June 28, 2008 backlog, 68% is related to Behavioral Analytics™ services, 22% is related to our Integrated Contact Solutions offerings and the remaining balance is from other Managed services.

The Company uses the term backlog with respect to its Managed services engagements to refer to the expected revenue to be received under the applicable contract, based on its currently contracted terms and, when applicable, currently anticipated levels of usage and performance. Actual usage and performance might be greater or less than anticipated. In general, the Company's Managed services contracts may be terminated by the customer without cause, but early termination by a customer usually requires a substantial early termination payment or forfeiture of prepaid contract amounts. Managed services contracts range from one to five years in duration.

**Second Quarter 2008 Compared with Second Quarter 2007****Net Revenue**

|                      | Second Quarter<br>2008 |                     | 2007                   |                     |
|----------------------|------------------------|---------------------|------------------------|---------------------|
|                      | Dollars in<br>Millions | % of Net<br>Revenue | Dollars in<br>Millions | % of Net<br>Revenue |
| <b>Revenue:</b>      |                        |                     |                        |                     |
| Consulting services  | \$ 8.8                 | 41%                 | \$ 13.6                | 55%                 |
| Managed services     | 9.4                    | 44%                 | 9.7                    | 40%                 |
| Services revenue     | <b>18.2</b>            | <b>85%</b>          | <b>23.3</b>            | <b>95%</b>          |
| Product              | 3.1                    | 15%                 | 1.3                    | 5%                  |
| <b>Net revenue</b>   | <b>21.3</b>            | <b>100%</b>         | <b>24.6</b>            | <b>100%</b>         |
| Reimbursed expenses  | 0.8                    |                     | 1.4                    |                     |
| <b>Total revenue</b> | <b>\$ 22.1</b>         |                     | <b>\$ 26.0</b>         |                     |

Net revenue is total revenue excluding reimbursable expenses that are billed to our clients. Our net revenue decreased 13% to \$21.3 million in the second quarter of 2008, a decrease of \$3.3 million, from \$24.6 million in the second quarter of 2007.

Revenue from Consulting services decreased by \$4.8 million to \$8.8 million in the second quarter of 2008 from \$13.6 million in the second quarter of 2007, a decrease of 36%. The decrease in Consulting services revenue is primarily due to a 39% decline in our Traditional CRM Service Line as a result of reduced spending by the two largest clients that use these services and because several projects were completed in 2007 for another large client. Consulting services from our Integrated Contact Solutions Service Line in the second quarter of 2008 declined 30% compared to the second quarter of 2007. The Company was restructured in December 2007 to focus on growth within this service line. However, this growth has been limited by current economic conditions that have increased the buying cycle and the length of time it takes to complete the contracting process. Our Behavioral Analytics Service Line declined 45% in the second quarter of 2008 compared to second quarter of 2007. This decline was driven by fewer active assessments being performed in the second quarter of 2008 as compared with the second quarter of 2007. The number of assessments contracted in the second quarter of 2008 increased compared to the number of assessments contracted in the second quarter of 2007. Spending by our Consulting services clients may fluctuate between periods in all service lines due to the short-term nature of these agreements.

Revenue from Consulting Services is a product of billable hours and our average billable rate. Billable hours are largely the function of our billable headcount and utilization rates. eLoyalty's average billable rate increased to \$156 in the second quarter of 2008 from \$152 in the second quarter of 2007. This increase was the result of a higher mix of Integrated Contact Solutions service line projects, which have higher average bill rates than eLoyalty's Traditional CRM Service Line. The impact of this increase on revenue was more than offset by a decrease in eLoyalty's headcount and lower utilization of billable consultants. Headcount decreased in the second quarter of 2008 because of staff reductions. Utilization of billable consultants, defined as billed time as a percentage of their total available time, declined to 69% for the second quarter of 2008 from 79% for the second quarter of 2007 as a result of delayed project initiation in the second quarter of 2008 and declining demand for our Traditional CRM consulting services.





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Revenue from Managed services was \$9.4 million in the second quarter of 2008, a decrease of \$0.3 million, or 2%, from \$9.7 million in the second quarter of 2007. The decrease in revenue from Managed services resulted from decline in demand for our Marketing Managed Services and a contract restructuring with a large Behavioral Analytics client partially offset by the continued growth of support and maintenance revenue from new and existing clients in our Integrated Contact Solutions Service Line.

Revenue from the sale of Product increased by 130%, or \$1.8 million, to \$3.1 million in the second quarter of 2008 from \$1.3 million in the second quarter of 2007. Product revenue includes a significant product sale to one client. There are significant variances in size among individual engagements within this Service Line, and the Company is not always selected as the Product supplier for the engagement. We resell Products to our clients to provide a complete solution when requested, but we do not focus our sales effort on driving Product revenue. As a result, annual and quarterly Product revenue may fluctuate significantly.

The Company's top 5 clients accounted for 42% of total revenue in the second quarter of 2008, compared to 43% in the second quarter of 2007. The top 10 clients accounted for 56% of total revenue in the second quarter of 2008, compared to 59% in the second quarter of 2007. The top 20 clients accounted for 74% of total revenue in the second quarter of 2008, compared to 77% of total revenue in the second quarter of 2007. Two clients accounted for 10% or more of total revenue in the second quarter of 2008. United HealthCare Services, Inc., accounted for 17% of total revenue in the second quarter of 2008, compared to 21% of total revenue in the second quarter of 2007. Discover Financial Services accounted for 11% of total revenue in the second quarter of 2008 compared with less than 1% of total revenue in the second quarter of 2007. Higher concentration of revenue with a single customer or a limited group of clients creates increased revenue risk if one of these clients significantly reduces its demand for our services.

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

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

#### **Cost of Services**

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

Cost of services in the second quarter of 2008 was \$13.6 million, or 75% of Service revenue, compared to \$15.2 million, or 65% of Services revenue, in the second quarter of 2007. The decrease was primarily due to lower internal and external resource costs of \$1.0 million, increased cost deferrals for Behavioral Analytics services net of amortized implementation costs of \$0.6 million, reduced discretionary travel expense of \$0.4 million, partially offset by third party support costs that related to the increase in Integrated Contact Solutions Managed service revenue of \$0.4 million. The percentage increase in Cost of services was primarily due to the impact of higher costs of 5%, lower utilization of our consulting services resources of 5% which was partially offset by higher billing rates of 1%.

#### **Cost of Product**

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

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

Cost of product in the second quarter of 2008 was \$2.4 million, or 78% of Product revenue, compared to \$0.9 million, or 68% of Product revenue in the second quarter of 2007. The cost increase is primarily due to the increase in Product revenue. The percentage increase was primarily due to the mix of vendor specific products sold in the second quarter of 2008.

### ***Selling, General and Administrative***

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

Selling, general and administrative expenses decreased \$0.9 million to \$11.2 million in the second quarter of 2008 from \$12.1 million in the second quarter of 2007. This decrease is primarily due to reduced discretionary travel expenses of \$0.5 million.

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

In late 2007, we restructured our business into two primary business units, Behavioral Analytics services and Integrated Contact Solutions/CRM. In connection with this change a number of cost reduction activities were undertaken, principally consisting of personnel reductions. Cash savings related to the cost reduction actions taken in late fiscal year 2007 are anticipated to be \$9.0 million in 2008. Cash savings related to cost reduction actions taken in the second quarter of 2008 are anticipated to be \$2.0 million annually. Substantially all severance and related costs associated with cost reduction activities should be paid out by the end of the third quarter of 2008, pursuant to agreements entered into with affected employees. See Note Four Severance and Related Costs .

Severance and related costs were \$0.3 million in the second quarter of 2008. The Company did not record any severance and related costs in the second quarter of 2007. The \$0.3 million of expense recorded in the second quarter of 2008 is primarily due to restructuring actions taken in 2008 for the elimination of seventeen positions.

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

Depreciation and amortization increased \$0.2 million, or 15%, to \$1.1 million in the second quarter of 2008 compared to \$0.9 million in the second quarter of 2007. The increase in depreciation is primarily related to an increased rate of investment in our Behavioral Analytics Service Line.

### ***Operating Loss***

Primarily as a result of the factors described above, we experienced an operating loss of \$7.3 million for the second quarter 2008, compared to an operating loss of \$4.5 million for the second quarter 2007.

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

Non-operating interest and other income (expense) decreased \$0.6 million to a nominal amount in the second quarter of 2008, compared to \$0.6 million in the second quarter of 2007. The \$0.6 million decrease was primarily related to lower average cash balances and lower average yields on our investments in the second quarter of 2008 compared to the second quarter of 2007 and \$0.1 million of interest expense related to our capital lease obligations in the second quarter of 2008. These lease obligations did not exist in the second quarter of 2007.

**Table of Contents****Income Tax Provision**

There was no appreciable income tax provision in the second quarter of 2008 or 2007. As of June 28, 2008, total deferred tax assets of \$52.8 million are offset by a valuation allowance of \$52.7 million. The level of uncertainty in predicting when we will return to profitability, sufficient to utilize our net U.S. and non-U.S. operating losses and realize our remaining deferred tax assets, requires that an income tax valuation allowance be recognized in the financial statements.

**Net Loss Available to Common Stockholders**

We reported a net loss available to common stockholders of \$7.6 million in the second quarter of 2008 compared to a net loss available to common stockholders of \$4.3 million in the second quarter of 2007. These losses include dividends to preferred shareholders of \$0.3 million and \$0.4 million in the second quarters of 2008 and 2007, respectively. The net loss was \$0.80 per share on a basic and diluted basis in the second quarter of 2008, compared to a net loss of \$0.52 per share on a basic and diluted basis in the second quarter of 2007.

**First Six Months of 2008 Compared with First Six Months of 2007****Net Revenue**

|                      | First Six Months Ended |                     | First Six Months Ended |                     |
|----------------------|------------------------|---------------------|------------------------|---------------------|
|                      | June 28, 2008          |                     | June 30, 2007          |                     |
|                      | Dollars in<br>Millions | % of Net<br>Revenue | Dollars in<br>Millions | % of Net<br>Revenue |
| <b>Revenue:</b>      |                        |                     |                        |                     |
| Consulting services  | \$ 19.4                | 44%                 | \$ 27.0                | 53%                 |
| Managed services     | 20.2                   | 45%                 | 18.5                   | 36%                 |
| Services revenue     | <b>39.6</b>            | <b>89%</b>          | <b>45.5</b>            | <b>89%</b>          |
| Product              | 4.9                    | 11%                 | 5.7                    | 11%                 |
| <b>Net revenue</b>   | <b>44.5</b>            | <b>100%</b>         | <b>51.2</b>            | <b>100%</b>         |
| Reimbursed expenses  | 1.5                    |                     | 2.7                    |                     |
| <b>Total revenue</b> | <b>\$ 46.0</b>         |                     | <b>\$ 53.9</b>         |                     |

Net revenue is total revenue excluding reimbursable expenses that are billed to our clients. Our net revenue decreased 13% to \$44.5 million in the first six months of 2008, a decrease of \$6.7 million, from \$51.2 million in the first six months of 2007.

Revenue from Consulting services decreased by \$7.6 million to \$19.4 million in the first six months of 2008 from \$27.0 million in the first six months of 2007, a decrease of 28%. The decrease in Consulting services revenue is primarily due to a 35% decline in our Traditional CRM Service Line driven by reduced spending by the two largest clients that utilize these services and the completion of several projects for another large client. Consulting services from our Integrated Contact Solutions Service Line in the first six months of 2008 declined 20% compared to the first six months of 2007. The Company was restructured in December 2007, to focus on growth within this service line. However, this growth has been limited by current economic conditions that have increased the buying cycle and length of time it takes to complete the contracting process. Our Behavioral Analytics Service Line grew 25% in the first six months of 2008, driven by a continuously increasing focus on the service line resulting in an increase in the number of assessments in the first six months of 2008 compared to the first six months of 2007. Spending by our Consulting services clients may fluctuate between periods in all service lines due to the short-term nature of these agreements.

Revenue from Consulting Services is a product of billable hours and our average billable rate. Billable hours are largely the function of our billable headcount and utilization rates. eLoyalty's average billable rate increased to \$157 in the first six months of 2008 from \$150 in the first six months of 2007. This increase was the result of a higher mix of Integrated Contact Solutions service line projects, which have higher average bill rates than eLoyalty's Traditional CRM Service Line. The impact of this increase on revenue was more than offset by a decrease in eLoyalty's headcount and lower utilization of billable consultants. Headcount



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decreased in the first six months of 2008 because of staff reductions. Utilization of billable consultants, defined as billed time as a percentage of their total available time, declined to 70% for the first six months of 2008 from 80% for the first six months of 2007 as a result of delayed project initiation in the first six months of 2008 and declining demand for our Traditional CRM consulting services.

Revenue from Managed services was \$20.2 million in the first six months of 2008, an increase of \$1.7 million, or 9%, from \$18.5 million in the first six months of 2007. The increase in Managed services revenue resulted from the continued growth of support and maintenance revenue from new and existing clients in our Integrated Contact Solutions Service Line, partially offset by decreased demand for our Marketing Managed Services and a contract restructuring with a large client for Behavioral Analytics services.

Revenue from the sale of Product decreased by 15%, or \$0.8 million, to \$4.9 million in the first six months of 2008 from \$5.7 million in the first six months of 2007. There are significant variances in size among individual engagements within this Service Line, and the Company is not always selected as the Product supplier for the engagement. We resell Products to our clients to provide a complete solution when requested, but we do not focus our sales effort on driving Product revenue. As a result, annual and quarterly Product revenue may fluctuate significantly.

The Company's top 5 clients accounted for 40% of total revenue in the first six months of 2008, compared to 43% in the first six months of 2007. The top 10 clients accounted for 56% of total revenue in the first six months of 2008, compared to 57% in the first six months of 2007. The top 20 clients accounted for 72% of total revenue in the first six months of 2008, compared to 76% of total revenue in the first six months of 2007. One customer, United HealthCare Services, Inc., accounted for 20% of total revenue in the first six months of 2008, compared to 25% of total revenue in the first six months of 2007. There were no other clients that accounted for 10% or more of total revenue in either year. Higher concentration of revenue with a single customer or a limited group of clients creates increased revenue risk if one of these clients significantly reduces its demand for our services.

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

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

#### **Cost of Services**

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

Cost of services in the first six months of 2008 was \$26.9 million, or 68% of Service revenue, compared to \$30.0 million, or 66% of Services revenue, in the first six months of 2007. The decrease in cost was primarily due to lower internal and external resource costs of \$1.8 million, increased cost deferrals for Behavioral Analytics services net of amortized implementation costs of \$1.1 million, reduced discretionary travel expense of \$0.9 million, partially offset by third party support costs that related to the increase in Integrated Contact Solutions Managed service revenue of \$0.9 million. The percentage increase in Cost of Services was primarily due to the impact of lower utilization of our consulting services resources of 5%, which were partially offset by higher billing rates of 2% and lower costs of 1%.

#### **Cost of Product**

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

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

Cost of product in the first six months of 2008 was \$3.8 million, or 78% of Product revenue, compared to \$4.4 million, or 77% of Product revenue in the first six months of 2007. The cost decrease is primarily due to the decrease in Product revenue. The percentage increase was primarily due to the mix of vendor specific products sold in the first six months of 2008.

### ***Selling, General and Administrative***

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

Selling, general and administrative expenses decreased \$1.8 million to \$22.7 million in the first six months of 2008 from \$24.5 million in the first six months of 2007. This decrease is primarily due to lower personnel costs of \$0.9 million relating to the fourth quarter restructuring actions and reduced discretionary travel expense of \$0.7 million.

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

In late 2007, we restructured our business into two primary business units, Behavioral Analytics and Integrated Contact Solutions/CRM. In connection with this change a number of cost reduction activities were undertaken, principally consisting of personnel reductions. Cash savings related to the cost reduction actions taken in late fiscal year 2007 are anticipated to be \$9.0 million in 2008. Cash savings related to cost reduction actions taken in the first six months of 2008 are anticipated to be \$2.0 million annually. Substantially all severance and related costs associated with cost reduction activities should be paid out by the end of the third quarter of 2008, pursuant to agreements entered into with affected employees. See Note Four Severance and Related Costs .

Severance and related costs was \$0.5 million in the first six months of 2008. The Company did not record any severance and related costs in the first six months of 2007. The \$0.5 million of expense recorded in the first six months of 2008 is primarily due to restructuring actions taken in 2008 for the elimination of seventeen positions and 2008 adjustments related to cost reduction activities for actions taken in late fiscal year 2007.

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

Depreciation and amortization increased \$0.4 million, or 19%, to \$2.1 million in the first six months of 2008 compared to \$1.7 million in the first six months of 2007. The increase in depreciation is primarily related to an increased rate of investment in our Behavioral Analytics Service Line.

### ***Operating Loss***

Primarily as a result of the factors described above, we experienced an operating loss of \$11.5 million for the first six months of 2008, compared to an operating loss of \$9.4 million for the first six months of 2007.

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

Non-operating interest and other income (expense) decreased \$0.8 million to \$0.1 million in the first six months of 2008, compared to \$0.9 million in the first six months of 2007. The \$0.8 million decrease was primarily related to lower average cash balances and lower average yields on our investments in the first six months of 2008 compared to the first six months of 2007 and \$0.3 million of interest expense related to our capital lease obligations in the first six months of 2008. These lease obligations did not exist in the first six months of 2007.

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### ***Income Tax Provision***

There was no appreciable income tax provision in the first six months of 2008 or 2007. As of June 28, 2008, total deferred tax assets of \$52.8 million are offset by a valuation allowance of \$52.7 million. The level of uncertainty in predicting when we will return to profitability, sufficient to utilize our net U.S. and non-U.S. operating losses and realize our remaining deferred tax assets, requires that an income tax valuation allowance be recognized in the financial statements.

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

We reported a net loss available to common stockholders of \$12.1 million in the first six months of 2008 compared to a net loss available to common stockholders of \$9.2 million in the first six months of 2007. These losses include dividends to preferred shareholders of \$0.6 million and \$0.7 million in the first six months of 2008 and 2007, respectively. The net loss was \$1.31 per share on a basic and diluted basis in the first six months of 2008, compared to a net loss of \$1.13 per share on a basic and diluted basis in the first six months of 2007.

### **Liquidity and Capital Resources**

#### ***Introduction***

Our principal capital requirements are to fund: working capital needs; capital expenditures for infrastructure and our Behavioral Analytics Service Line; other investments in support of revenue generation and growth; and payment of Series B preferred stock dividends. As of June 28, 2008, our principal current capital resources consist of our cash and cash equivalent balances of \$17.2 million, which includes \$1.6 million in foreign bank accounts and restricted cash of \$3.7 million.

Our cash and cash equivalents position decreased \$6.7 million, or 28%, as of June 28, 2008 from \$23.9 million as of December 29, 2007. The decrease in cash, in the first six months of 2008, was primarily the result of an operating loss excluding non-cash items; a decrease in working capital; capital expenditures; acquisition of treasury stock; and dividend payments. The \$1.2 million increase in restricted cash was used as collateral for a letter of credit issued in support of future capital lease obligations. See **Bank Facility** below for a description of the contractual requirements related to restricted cash.

#### ***Cash Flows from Operating Activities***

The Company used \$3.0 million of cash in operating activities during the first six months of 2008 compared to generating \$3.7 million of cash during the first six months of 2007. Net cash from operating activities decreased primarily because of an increase in working capital partially offset by a decrease in net loss before depreciation, amortization and stock-based compensation and an increase in long-term liabilities. Cash used in operating activities during the first six months of 2008 consisted primarily of an increase in working capital of \$0.8 million, a decrease in long-term liabilities of \$1.5 million and a net loss before depreciation, amortization and stock-based compensation of \$0.6 million. Cash generated from operating activities during the first six months of 2007 consisted primarily of a decrease in working capital of \$3.3 million, and an increase in long-term liabilities of \$1.6 million, partially offset by a net loss before depreciation, amortization and stock-based compensation of \$0.7 million and an increase in other long-term assets of \$0.5 million.

Average Days Sales Outstanding ( **DSO** ) was 49 days at June 28, 2008 compared to 47 days at December 29, 2007 and 49 days at June 30, 2007. We do not expect any significant collection issues with our clients. At June 28, 2008, there remained \$0.1 million of unpaid severance and related costs. See Note Four **Severance and Related Costs** .

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***Cash Flows from Investing Activities***

The Company used \$0.4 million and \$2.2 million of cash in investing activities during the first six months of 2008 and 2007, respectively, primarily to purchase computer hardware and software. We currently expect our capital investments to be between \$1 million to \$2 million for the remainder of fiscal year 2008 and plan on funding a vast majority of these purchases with capital leases.

***Cash Flows from Financing Activities***

The Company used \$4.4 million and \$2.8 million of cash in financing activities during the first six months of 2008 and 2007, respectively. Net cash outflows during 2008 consisted primarily of \$2.5 million to acquire treasury stock, \$1.2 million increase in restricted cash to support our collateral requirements for our capital lease agreements and \$0.7 million to pay dividends on Series B convertible preferred stock. Net cash outflows during 2007 consisted primarily of \$2.3 million to acquire treasury stock and \$0.7 million to pay dividends on Series B convertible preferred stock partially offset by \$0.2 million from stock purchase plans. The treasury stock acquired in each year reflects shares that were obtained to meet employee tax obligations associated with the Salary Replacement Program and other stock award vestings. Prior to February 1, 2007, the shares associated with these employee tax obligations were cancelled and not recorded as treasury stock. See Note Three Stock-Based Compensation for a further discussion on these programs.

A semi-annual dividend payment of approximately \$0.6 million is expected to be paid in future periods on the Series B preferred stock. The amount of each such dividend would be decreased for any conversions of the Series B preferred stock into common stock, although any such conversions would require that we pay accrued but unpaid dividends at the time of conversion. The Company also expects to acquire treasury stock of between \$0.5 million and \$0.8 million per quarter to meet employee tax obligations associated with the various stock-based compensation programs.

***Liquidity***

Our near-term capital resources consist of our current cash balance together with anticipated future cash flows and financing from capital leases. Our balance of cash and cash equivalents was \$13.5 million as of June 28, 2008. In addition, our restricted cash of \$3.7 million with Bank of America (the Bank) at June 28, 2008 is available to support letters of credit issued under our credit facility (as described below) to support collateral requirements for our capital lease agreements and to accommodate a credit requirement at the Bank associated with the purchase and transfer of foreign currencies and credit card payments. For 2008, we will continue to see an increased use of stock-based compensation compared to 2007. See Salary Replacement Program under Note Three Stock-Based Compensation.

The Company is experiencing increasing traction of the Company's Behavioral Analytics Services. In addition, the Company is optimistic about the market potential for this Service. Given the need to continue to make significant investments to build out the Behavioral Analytics Services, including, but not limited to large increases in its sales force, and given the recent and expected future weakness in its Traditional Consulting business, on August 7, 2008, eLoyalty filed an S-3 with the Securities and Exchange Commission to raise \$15.0 million in a proposed Rights Offering.

***Bank Facility***

The Company maintains a Loan Agreement with the Bank. The maximum principal amount of the secured line of credit under the agreement (the Facility) is \$5.0 million as of June 28, 2008. The Facility requires the Company to maintain a minimum cash and cash equivalent balance within a secured account at the Bank. The balance in the secured account cannot be less than the outstanding balance drawn on the Facility line of credit, and letter of credit obligations under the Facility, plus a de minimis reserve to accommodate a Bank credit requirement associated with the purchase and transfer of foreign currencies and credit card payments. Available credit under the Facility has been reduced by \$3.7 million related to letters of credit issued under the Facility to support our capital lease obligations and to cover the foreign currency and credit card payment requirements. As a result, \$1.3 million remains available under the Facility at June 28, 2008. Loans under the Facility bear interest at the Bank's prime rate or, at the Company's election, an alternate rate of LIBOR (London InterBank Offering Rate) plus 0.75%. We did not have any borrowings or interest expense under the Facility during the first six months of 2008 or 2007.



**Table of Contents****Accounts Receivable Customer Concentration**

At June 28, 2008, one customer, United HealthCare Services, Inc., accounted for 22% of total gross accounts receivable. We collected 71% of that amount through July 31, 2008. Of the total June 28, 2008 gross accounts receivable, we collected 59% as of July 31, 2008. Because we have a high percentage of our revenue dependent on a relatively small number of clients, delayed payments by a few of our larger clients could result in a reduction of our available cash.

**Capital Lease Obligations**

Capital lease obligations at June 28, 2008 and December 29, 2007 were \$2.6 million and \$1.5 million, respectively. We entered into a capital lease agreement with a lease company to lease hardware and software. We expect capital lease obligations to be between \$1 million to \$2 million for the remainder of fiscal year 2008 as we continue to expand our investment in the infrastructure for Behavioral Analytics services. At the current time the Company is required to issue an irrevocable letter of credit for 60% of the lease amount as additional consideration for the duration of the lease on future leases. There were no capital lease obligations at June 30, 2007. The Company will continue to fund most capital investments with capital leases.

**Contractual Obligations**

Cash will also be required for operating leases and non-cancelable purchase obligations as well as various commitments reflected as liabilities on our balance sheet at June 28, 2008. These commitments are as follows:

(In millions)

|                                | Total   | Less Than 1 Year | 1-3 Years | 3 5 Years | More Than 5 Years |
|--------------------------------|---------|------------------|-----------|-----------|-------------------|
| <b>Contractual Obligations</b> |         |                  |           |           |                   |
| Letters of credit              | \$ 3.5  | \$               | \$ 3.5    | \$        | \$                |
| Operating leases               | \$ 4.7  | \$ 2.1           | \$ 1.7    | \$ 0.7    | \$ 0.2            |
| Capital leases                 | \$ 3.3  | \$ 1.3           | \$ 2.0    | \$        | \$                |
| Severance and related costs    | \$ 0.1  | \$ 0.1           | \$        | \$        | \$                |
| Purchase obligations           | \$ 6.3  | \$ 6.3           | \$        | \$        | \$                |
| Total                          | \$ 17.9 | \$ 9.8           | \$ 7.2    | \$ 0.7    | \$ 0.2            |

Due to the existence of the Company's net operating loss carryover as described in Note Seven Income Taxes in Part II Item 8 of the Form 10-K for the year ended December 29, 2007, no net contractual obligations related to FASB Interpretation No. 48 ( FIN 48 ) adjustments exist as of June 28, 2008.

**Letters of Credit**

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

**Leases**

These amounts reflect future principal, interest and executory costs of the leases entered into by the Company for technology and office equipment as well as office and data center space. Liabilities for the principal portion of the capital lease obligations are reflected on our balance sheet as of June 28, 2008.

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

Severance and related costs reflect payments the Company is required to make in future periods for severance and other related costs due to cost reduction activities in the second quarter of 2008 and prior periods. Liabilities for these required payments are reflected on our balance sheet as of June 28, 2008.

***Purchase Obligations***

Purchase obligations include \$5.5 million of commitments reflected as liabilities on our balance sheet as of June 28, 2008 as well as \$0.8 million of non-cancellable obligations to purchase goods or services in the future.

**Recent Accounting Pronouncements**

In May 2008, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 162 The Hierarchy of Generally Accepted Accounting Principles . SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. SFAS No. 162 becomes effective sixty days following the Securities and Exchange Commission s approval of Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles . The Company is currently evaluating the potential impact, if any, of the adoption of FAS No. 162 on its consolidated financial statements.

In April 2008, the FASB issued FASB Staff Position No. FAS 142-3, *Determination of the Useful Life of Intangible Assets* ( FSP No. FAS 142-3 ). FSP No. FAS 142-3 requires companies estimating the useful life of a recognized intangible asset to consider their historical experience in renewing or extending similar arrangements or, in the absence of historical experience, to consider assumptions that market participants would use about renewal or extension as adjusted for SFAS No. 142 s, *Goodwill and Other Intangible Assets*, entity-specific factors. FSP No. FAS 142-3 will be effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the potential impact of adoption of FSP No. FAS 142-3 on its consolidated financial statements. However, the Company does not expect the adoption of FSP No. FAS 142-3 to have a material effect on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company did not elect the fair value option permitted under SFAS 159 so adoption had no impact on its financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements , which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for fiscal years beginning after November 15, 2007. On February 14, 2008 the FASB issued FSP FAS No. 157-1 Application of FASB Statement No. 157 to FASB Statement 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement Under Statement 13 that amends SFAS No. 157 to exclude its application for purposes of lease classification or measurement under SFAS 13. On February 12, 2008 the FASB issued Staff Position Financial Accounting Standard (FSP FAS) No. 157-2 Effective Date of FASB Statement No. 157 that amends SFAS No. 157 to delay the effective date for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis to fiscal years beginning after November 15, 2008. The Company adopted the required provisions of SFAS No. 157-1 effective January 1, 2008 and there was no material effect on its consolidated financial statements. The company has adopted SFAS 157-2 to delay the adoption effects related to non-financial assets and does not anticipate there will be a material effect on its consolidated financial statements. See Note Eleven for additional information related to the adoption of FAS 157 related to financial assets.

**Table of Contents****Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We provide solutions to clients in a number of countries including the United States, Australia, Canada, Germany, Ireland and the United Kingdom. For the quarter ended June 28, 2008 and June 30, 2007, 7% and 6%, respectively, of our net revenue was denominated in foreign currencies. Historically, we have not experienced material fluctuations in our results of operations due to foreign currency exchange rate changes. We do not currently engage, nor is there any plan to engage, in hedging foreign currency risk.

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

**Item 4. Controls and Procedures****(a) Evaluation of Disclosure Controls and Procedures**

Based on their evaluation for the period covered by this Form 10-Q, eLoyalty's Chief Executive Officer and Chief Financial Officer have concluded that, as of June 28, 2008, the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) are effective.

**(b) Changes in Internal Control over Financial Reporting**

There has been no change in eLoyalty's internal control over financial reporting that occurred during the second quarter of 2008 that has materially affected, or is reasonably likely to materially affect, eLoyalty's internal control over financial reporting.

**Part II. Other Information****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****Repurchase of Equity Securities**

The following table provides information relating to the Company's purchase of shares of its common stock in the second quarter of 2008. All of these purchases reflect shares withheld to satisfy tax withholding obligations related to stock awarded under the Salary Replacement Program or vestings under other stock programs. The Company has not adopted a common stock repurchase plan or program.

| Period                                      | Total Number<br>of Shares<br>Purchased | Average<br>Price Paid<br>Per Share |
|---|--|------------------------------------|
| <b>March 30, 2008</b> <b>April 29, 2008</b> |  |                                    |
| Common stock                                | 68,960                                 | \$ 8.03                            |
| <b>April 30, 2008</b> <b>May 29, 2008</b>   |  |                                    |
| Common stock                                | 54,762                                 | \$ 6.60                            |
| <b>May 30, 2008</b> <b>June 28, 2008</b>    |  |                                    |
| Common stock                                | 38,111                                 | \$ 8.24                            |
| <b>Total</b>                                |  |                                    |
| Common stock                                | 161,833                                | \$ 7.60                            |

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**Item 4. Submission of Matters to a Vote of Security Holders**

Our 2008 Annual Meeting of Stockholders (the Annual Meeting ) was held on May 15, 2008. Represented at the Annual Meeting, either in person or by proxy, were 12,349,539 voting shares, consisting of common stock and Series B preferred stock. This represented more than a majority of the shares of eLoyalty common and Series B preferred stock outstanding on the record date for the Annual Meeting and therefore constituted a quorum. Each share present was entitled to one vote.

The following actions were taken at the Annual Meeting:

1. Messrs. Conway and Murray, the nominees for election as Class III Directors at the Annual Meeting, were elected to serve as members of eLoyalty's Board of Directors for a three year term expiring in 2011. The vote for Mr. Conway was: 10,840,923 shares voted in favor of election, and 1,508,616 votes withheld. The vote for Mr. Murray was: 12,293,173 shares voted in favor of election and 56,366 votes withheld. The terms of office of the following directors continued after the meeting: Messrs. Coxe and Kohler (whose terms expire at the 2009 Annual Meeting) and Messrs. Feinberg and Staley (whose terms expire at the 2010 Annual Meeting).
2. Stockholders ratified the amendment and restatement of the 1999 Stock Incentive Plan and the 1,500,000 increase in the number of shares available under the Plan. The vote for the amendment was: 8,643,128 shares voted in favor, 1,671,367 voted against it, 922 shares abstained from voting and 2,034,112 broker non-votes.
3. Stockholders ratified the appointment of Grant Thornton LLP as eLoyalty's independent public accountants for its current fiscal year ending December 27, 2008. The vote was: 12,289,167 shares voted in favor of the ratification of such appointment; 18,029 voted against it, and 42,342 shares abstained from voting.

**Item 6. Exhibits**

- \*10.1 eLoyalty Corporation 2006/2007 Salary Replacement Program (as Amended and Restated as of February 13, 2008), incorporated by reference herein to Exhibit 99.1 to the Company's Current Report on Form 8-K filed February 19, 2008.
- \*\*10.2 Amended and Restated Executive Employment Agreement, effective as of May 15, 2008 between Steven C. Pollema and eLoyalty.
- \*\*10.3 Indemnification Agreement, effective as of May 15, 2008 between Steven C. Pollema and eLoyalty.
- \*\*10.4 Second Amendment to Amended and Restated Employment Agreement, effective as of May 16, 2008 between Kelly D. Conway and eLoyalty.
- \*\*10.5 First Amendment to Amended and Restated Employment Agreement, effective as of May 16, 2008 between Steven H. Shapiro and eLoyalty.
- \*\*10.6 First Amendment to Executive Employment Agreement, effective as of May 16, 2008 between Christopher Min and eLoyalty.
- \*\*31.1 Certification of Kelly D. Conway under Section 302 of the Sarbanes-Oxley Act of 2002.
- \*\*31.2 Certification of Christopher Min under Section 302 of the Sarbanes-Oxley Act of 2002.
- \*\*32.1 Certification of Kelly D. Conway and Christopher Min under Section 906 of the Sarbanes-Oxley Act of 2002.

- \* Compensatory contract, plan or arrangement.
- \*\* Filed herewith.

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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, in the City of Lake Forest, State of Illinois, on August 7, 2008.

**eLOYALTY CORPORATION**

By /s/ CHRISTOPHER MIN  
Christopher Min  
Vice President and Chief Financial Officer  
(Duly authorized signatory and Principal Financial  
and Accounting Officer)