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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

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**FORM 10-Q**

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

**For the quarterly period ended November 30, 2007**

**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 000-25249**



**Intraware, Inc.**

(Exact name of Registrant as Specified in its Charter)

**Delaware**

(State or Other Jurisdiction of Incorporation or Organization)

**68-0389976**

(I.R.S. Employer Identification Number)

**25 Orinda Way**

**Orinda, California 94563**

(Address of Principal Executive Offices including Zip Code)

**(925) 253-4500**

(Registrant's Telephone Number, Including Area Code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file reports), and (2) has been subject to such filing requirements for the past 90 days.

YES ☒ NO ☐

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

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☒

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

YES ☐ NO ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class  
Common Stock, \$0.001 par value

Outstanding at December 31, 2007  
6,249,198

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## Part I - FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

#### INTRAWARE, INC.

#### BALANCE SHEETS

(in thousands, except per share amounts)  
(unaudited)

	November 30, 2007	February 28, 2007
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 12,279	\$ 12,260
Accounts receivable, net	1,282	1,110
Costs of deferred revenue	550	490
Other current assets	476	263
Total current assets	14,587	14,123
Costs of deferred revenue, less current portion	246	432
Property and equipment, net	356	407
Capitalized software, net	410	180
Other assets	233	217
Total assets	<u>\$ 15,832</u>	<u>\$ 15,359</u>
<b>LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK &amp; STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 283	\$ 797
Accrued expenses	795	1,003
Deferred revenue	3,083	2,576
Total current liabilities	4,161	4,376
Deferred revenue, less current portion	660	681
Total liabilities	4,821	5,057
Commitments and contingencies (Note 4)		
Redeemable convertible preferred stock; \$0.0001 par value; 10,000 shares authorized:		
Series A; 28 shares issued and outstanding at November 30, 2007 and February 28, 2007 (aggregate liquidation preference of \$500 at November 30, 2007 and February 28, 2007)	449	449
Series B; 1 shares issued and outstanding at November 30, 2007 and February 28, 2007, (aggregate liquidation preference of \$6,000 at November 30, 2007 and February 28, 2007)	5,701	5,701
Total redeemable convertible preferred stock	6,150	6,150
Stockholders' equity:		
Common stock; \$0.0001 par value; 50,000 shares authorized; 6,235 and 6,134 shares issued and outstanding at November 30, 2007 and February 28, 2007, respectively	1	1
Additional paid-in-capital	166,248	165,293
Accumulated deficit	(161,388)	(161,142)
Total stockholders' equity	4,861	4,152
Total liabilities, redeemable convertible preferred stock and stockholders' equity	<u>\$ 15,832</u>	<u>\$ 15,359</u>

See notes to unaudited interim financial statements.

INTRAWARE, INC.

STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)  
(unaudited)

	For the three months ended		For the nine months ended	
	November 30, 2007	November 30, 2006	November 30, 2007	November 30, 2006
Revenues	\$ 3,118	\$ 2,803	\$ 9,048	\$ 7,998
Cost of revenues	1,079	1,372	3,176	3,520
Gross profit	2,039	1,431	5,872	4,478
Operating expenses:				
Sales and marketing	676	853	1,987	2,327
Product development	343	328	1,117	1,309
General and administrative	1,087	1,082	3,435	3,425
Loss (gain) on disposal of assets	(1)	-	25	-
Total operating expenses	2,105	2,263	6,564	7,061
Loss from operations	(66)	(832)	(692)	(2,583)
Interest expense	-	(9)	-	(30)
Interest and other income	144	147	446	581
Net income (loss)	\$ 78	\$ (694)	\$ (246)	\$ (2,032)
Basic and diluted net income (loss) per share	\$ 0.01	\$ (0.11)	\$ (0.04)	\$ (0.33)
Weighted average shares - basic	6,229	6,131	6,199	6,130
Weighted average shares - diluted	7,465	6,131	6,199	6,130

See notes to unaudited interim financial statements.

# INTRAWARE, INC.

## STATEMENTS OF CASH FLOWS

(in thousands)  
(unaudited)

	For the nine months ended	
	November 30, 2007	November 30, 2006
Cash flows from operating activities:		
Net loss	\$ (246)	\$ (2,032)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	241	321
Provision for doubtful accounts	-	(22)
Stock-based compensation	539	866
Loss on disposal of assets	25	-
Changes in assets and liabilities:		
Accounts receivable	(172)	(96)
Costs of deferred revenue	144	(280)
Other assets	(230)	(80)
Accounts payable	(492)	385
Accrued liabilities	(208)	31
Deferred revenue	487	976
Net cash provided by operating activities	<u>88</u>	<u>69</u>
Cash flows from investing activities:		
Purchases of property and equipment	(93)	(113)
Capitalized software	(354)	(139)
Proceeds from sale of assets	4	-
Net cash used in investing activities	<u>(443)</u>	<u>(252)</u>
Cash flows from financing activities:		
Proceeds from notes payable	-	137
Principal payments on notes payable	-	(327)
Proceeds from issuance of common stock	374	60
Net cash provided by (used in) financing activities	<u>374</u>	<u>(130)</u>
Net increase (decrease) in cash and cash equivalents	19	(313)
Cash and cash equivalents at beginning of the period	12,260	12,650
Cash and cash equivalents at end of the period	<u>\$ 12,279</u>	<u>\$ 12,337</u>
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ -	\$ 31
Supplemental non-cash activity:		
Purchases of property and equipment included in accounts payable	\$ 15	\$ 79

See notes to unaudited interim financial statements.

## **INTRAWARE, INC.**

### **NOTES TO UNAUDITED INTERIM FINANCIAL STATEMENTS**

#### **NOTE 1. BASIS OF PRESENTATION**

The accompanying unaudited interim financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission, or SEC. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted under these rules and regulations. However, management believes the disclosures are adequate to ensure the information presented is not misleading. The balance sheet at February 28, 2007 has been derived from the audited financial statements, but does not include all disclosures required by generally accepted accounting principles. These unaudited interim financial statements should be read in conjunction with the audited financial statements and accompanying notes in our Annual Report on Form 10-K for the fiscal year ended February 28, 2007, filed with the SEC on April 26, 2007.

In the opinion of management, all adjustments, consisting only of normal recurring items considered necessary for a fair statement, have been included in the accompanying unaudited interim financial statements. The results of operations for the interim periods presented are not necessarily indicative of operating results to be expected for any subsequent interim period or for the fiscal year ending February 29, 2008.

We have incurred losses from operations during each fiscal year since inception and have incurred negative cash flows from operations during each fiscal year since inception, with the exception of our most recent fiscal year ended February 28, 2007. Net loss for the nine months ended November 30, 2007 decreased from our prior year loss for the corresponding period. We recorded net income for the three months ended November 30, 2007 of approximately \$0.1 million. For the nine months ended November 30, 2007, we recorded cash provided by operating activities of approximately \$0.1 million, which was a slight increase from cash provided by operations from the corresponding period in the prior year.

#### **NOTE 2. SIGNIFICANT ACCOUNTING POLICIES**

##### **Revenue Recognition**

We recognize revenue when all of the following conditions are met:

- There is persuasive evidence of an arrangement;
- We have provided the service to the customer, made the software available for customer download through our website, or shipped the software to the customer;
- We believe collection of fees is reasonably assured; and
- The amount of fees to be paid by the customer is fixed or determinable.

Our revenue results primarily from three types of arrangements: (1) sales of our SubscribeNet digital delivery service, which we refer to as our SubscribeNet service, to software vendors and other companies that distribute software as part of their business; (2) professional services to such customers in connection with customization of our SubscribeNet service, data conversion, and integration of our SubscribeNet service with other third party software; and (3) resale of third-party services or licenses complementary to our SubscribeNet service, including e-commerce. In addition, if appropriate opportunities present themselves in the future, we may generate revenue from the licenses of our proprietary software, along with related maintenance and support, to companies using our software internally or to companies using it to provide web-based services to their customers.

We defer revenues related to our SubscribeNet service and generally recognize them ratably over the term of the service arrangement. The typical subscription term is one year, although some terms may either be shorter or

extend up to three years. Our SubscribeNet service agreements are generally noncancelable, although customers usually have the right to terminate for cause if we materially fail to perform. A majority of our SubscribeNet service implementations for new customers involve customization essential to the functionality of the service. In these cases, we defer revenue recognition until the service go-live date and then recognize the SubscribeNet service revenue ratably over the remaining contract term. The go-live date is the later of the customer acceptance date or the point at which no additional customization is required. If the implementation fee is bundled with the recurring SubscribeNet service fee, it is recognized over the same period as the SubscribeNet service fee. If the implementation fee is charged separately, then the associated revenue is recognized in accordance with our professional services revenue recognition policy, described below. Our SubscribeNet service agreements normally provide a set period (generally five days) for a customer to evaluate a completed implementation, and also provide for deemed acceptance if the customer has not affirmatively rejected the implementation within such period. We typically rely on such deemed acceptance by most of our customers.

As stated above, in addition to implementations, we also provide other professional services to our customers related to our SubscribeNet service. Generally, these professional services do not provide stand-alone value to a customer. We defer recognition of this revenue until the acceptance of the professional services, similar to the manner in which we treat SubscribeNet service revenues discussed above. Such professional services revenues are recognized ratably over the longer of the remaining estimated customer life or the remaining contract term, commencing with the acceptance of the professional services. In some instances, the fees related to the implementation of the SubscribeNet service and other professional services are bundled with the SubscribeNet service fee without specifically stating the fees attributable to each portion of the services. In these instances, the professional services fees are recognized from acceptance of the professional services through the end of the remaining contract term on a ratable basis with the SubscribeNet service fee.

Revenues related to our resale of third-party services or software licenses complementary to our SubscribeNet service are generally recognized as the service or license is provided. If the resold service or license involves customization essential to the functionality of such service or software license, the fees charged for the customization are recognized as revenue in the same manner as professional services discussed above. Resold services or licenses are recognized as revenue based on the gross fee charged to the customer, since we bear the credit risk for resold services or licenses, have latitude in establishing pricing, and are primarily responsible for acceptability of the services or licenses delivered. In addition, costs paid to the third-party providers are recorded as cost of revenues and recognized over the same period as the related revenue.

We also recognize revenues related to variable billings of the SubscribeNet service for certain existing customers. When such customers exceed their maximum commitment levels for specified SubscribeNet service metrics in any given period, the associated revenues are recognized according to the provisions specified for such overages.

### **Deferred Costs**

We capitalize direct costs of revenues related to significant SubscribeNet service implementations and established professional services contracts associated with our SubscribeNet services. Direct costs include compensation and payroll-related benefits directly related to the time spent on significant implementation and professional services activities. These costs are recognized over the same period the related revenue is recognized (see **Revenue Recognition** above). Costs associated with professional services involving significant new functionality for the SubscribeNet service that are partially or fully funded by customers, but which do not qualify as funded research and development activities, are expensed as costs of revenues as incurred until a working model is delivered to the customer. Once a working model has been delivered, all additional direct costs are capitalized in the same manner discussed above.

Estimated customer life requires that we periodically estimate the projected life of our existing customers based on historical information such as customer renewal rates. Any changes in our estimated customer life estimates could result in corresponding changes to our recognition of deferred revenues and costs. A 10% increase in our estimated customer life during the three and nine months ended November 30, 2007 would have caused a decrease in the amortization of both deferred revenues and deferred costs of revenues, resulting in an immaterial decrease to our net income and an immaterial increase to our net loss, respectively. At November 30, 2007, we had

approximately \$0.8 million in capitalized costs relating to deferred revenues. We expense customer acquisition costs, including sales commissions, as incurred.

We also defer legal costs incurred in connection with patent applications. As of November 30, 2007, we had approximately \$0.2 million in deferred legal costs related to patent applications. Upon issuance of a patent, the deferred legal costs for that patent are expensed ratably over the patent's estimated useful life.

## Stock-Based Compensation

In March 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 123(R), *Share Based Payment* (SFAS 123(R)), which addressed the accounting for share-based payment transactions in which a company receives employee services in exchange for either equity instruments of the company or liabilities that are based on the fair value of the company's equity instruments, or that may be settled by the issuance of such equity instruments. In March 2005, the SEC issued Staff Accounting Bulletin (SAB) No. 107 (SAB 107) regarding its interpretation of SFAS 123(R).

Following the guidance prescribed in SAB 107, on March 1, 2006 we adopted SFAS 123(R) using the modified prospective method and, accordingly, have not restated the results of income from prior interim periods and fiscal years. Under SFAS 123(R), we measure compensation cost for all stock-based awards at fair value on the date of grant and recognize compensation expense on a straight-line basis over the service period that the awards are expected to vest. Stock options and awards issued under our equity plans, which generally vest over a three to four-year service period, as well as stock purchases under our Employee Stock Purchase Plan (ESPP), are subject to SFAS 123(R). We adopted and implemented our 2006 Equity Incentive Plan during the fiscal year ended February 28, 2007. See our Annual Report on Form 10-K for the fiscal year ended February 28, 2007 for further discussion on our 2006 Equity Incentive Plan.

We are using the Black-Scholes model to value the compensation expense associated with our stock-based awards under SFAS 123(R). In addition, we estimate forfeitures when recognizing compensation expense, and we will adjust our estimate of forfeitures over the requisite service period based on the extent to which actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized through a catch-up adjustment in the period of change and will also impact the amount of compensation expense to be recognized in future periods.

## Net income (loss) per share

The computation of basic and diluted earnings per common share was as follows:

	For the three months ended		For the nine months ended	
	November 30, 2007	November 30, 2006	November 30, 2007	November 30, 2006
<b>Numerator:</b>				
Net income (loss)	\$ 78	\$ (64)	\$ (246)	\$ (2032)
<b>Denominator:</b>				
Weighted average shares outstanding - basic	6,229	6,131	6,199	6,130
Dilutive effect of shares from exercise of stock options, and vesting of restricted stock units	208	-	-	-
Dilutive effect of convertible preferred stock	1,028	-	-	-
Weighted average shares outstanding - diluted	7,465	6,131	6,199	6,130
Basic net income (loss) per share	\$ 0.01	\$ (0.11)	\$ (0.04)	\$ (0.33)
Diluted net income (loss) per share	\$ 0.01	\$ (0.11)	\$ (0.04)	\$ (0.33)



Basic earnings per common share was computed using net income and the weighted average number of common shares outstanding during the period. Diluted earnings per common share was computed using net income and the weighted average number of common shares outstanding plus potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include the assumed exercise of outstanding stock options and assumed vesting of outstanding restricted stock units using the treasury stock method, as well as the assumed conversion of convertible preferred stock using the if-converted method.

For the three months ended November 30, 2007, we excluded approximately 669,000 outstanding stock options as well as warrants to purchase approximately 84,000 shares of common stock from the calculation of diluted earnings per common share because the exercise prices of these stock options and warrants were greater than or equal to the average market value of our common shares. These options and warrants may be included in future calculations if the average market value of our common shares becomes greater than the exercise price of such options and warrants. For the nine months ended November 30, 2007 we excluded stock options, preferred stock and warrants exercisable for 2,191,297 shares of common stock. For the three and nine months ended November 30, 2006 we excluded stock options, preferred stock and warrants exercisable for 2,486,031 shares of common stock. These securities are not included in the computation of diluted net loss per share because of the losses, but could potentially dilute earnings per share in the future.

### **Software Development Costs**

We account for costs incurred for computer software developed or obtained for internal use in accordance with Statement of Position (SOP) No. 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (SOP 98-1). SOP 98-1 requires companies to capitalize qualifying computer software costs that are incurred during the application and development stage and amortize them over the software's estimated useful life.

### **Recent Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which replaced the different definitions of fair value set forth in the accounting literature with a single definition. SFAS 157 defines fair value as the price that would be received by selling an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. SFAS 157 is effective for fair-value measurements already required or permitted by other standards for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the impact of adopting SFAS 157 on our financial position, results of operations, and cash flows.

In July 2006, the FASB issued Financial Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* (FIN 48), which changed the accounting for income taxes. FIN 48 specifies, among other provisions, how tax benefits for uncertain tax positions are to be recognized, measured, and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax positions should be classified on the balance sheet; and provides transition and interim period guidance. We adopted FIN 48 on March 1, 2007 and, as a result of its implementation, we did not recognize any adjustments in the liability for unrecognized tax benefits. We do not have any accrued interest or penalties associated with unrecognized tax benefits. We will account for any future interest related to uncertain tax positions as interest expense, and for penalties as tax expense.

### NOTE 3. CHANGES IN STOCKHOLDERS' EQUITY

During the nine months ended November 30, 2007, our stockholders' equity changed as follows (in thousands):

	Common stock		Additional paid-in capital	Accumulated deficit	Stockholders' equity
	Shares	Amount			
Balance at February 28, 2007	6,134	\$ 1	\$ 165,293	\$ (161,142)	\$ 4,152
Exercise of stock options	68	-	240	-	240
Issuance of common stock for employee stock purchase program	33	-	134	-	134
Stock based compensation			581		581
Net loss	-	-	-	(246)	(246)
Balance at November 30, 2007	6,235	\$ 1	\$ 166,248	\$ (161,388)	\$ 4,861

### NOTE 4. CONTINGENCIES

#### Indemnifications

In the course of our business, we have made commitments and provided indemnities and guarantees under which we may be required to make payments. The indemnities include:

- *Intellectual Property Indemnities to Customers and Resellers.* The customer and reseller agreements for our SubscribeNet service typically contain provisions that indemnify our customers or resellers for damages and costs resulting from claims alleging that our services infringe the intellectual property rights of a third-party. We have also entered into software license agreements indemnifying the licensees for damages and costs resulting from claims alleging that our software infringes third-party intellectual property rights. The duration of these indemnities is typically unlimited. Our potential payments under these indemnities are in some cases limited (e.g., to the fees paid to us under the contract or another set amount) and are in other cases unlimited. Where we have given such indemnities for third-party software licenses that we resold, we have typically received similar indemnities from the enterprise technology company licensor. We plan to continue to enter into SubscribeNet service agreements with customers and resellers, to continue to license software, and to continue to provide industry-standard indemnities to our service customers, resellers and licensees.
- *Indemnities to Private Investors.* We have made representations and warranties to the investors and placement agents in our private placements of stock, and have agreed to indemnify them for any damages and costs they may incur as a result of our breach of those representations and warranties. We also have signed investor and/or registration rights agreements with private investors under which we have agreed to indemnify them for damages they may incur as a result of any material misstatements or omissions in our registration statements.
- *Indemnities to Directors and Officers.* We have agreed to indemnify our directors and officers for damages and costs incurred in the performance of their duties, to the extent permitted by Delaware law. The duration of, and our potential payments under, these indemnities are unlimited, subject to Delaware law.

We historically have received a very limited number of requests for indemnification under these agreements and have not been required to make any material payments under them. Accordingly, we believe that the fair value of each of these indemnification agreements is minimal and therefore have not recorded a liability related to these indemnification provisions.

## **Legal Proceedings**

### ***In re Intraware, Inc. Initial Public Offering Securities Litigation***

In October 2001, we were served with a summons and complaint in a purported securities class action lawsuit. On or about April 19, 2002, we were served with an amended complaint in this action, which is now titled *In re Intraware, Inc. Initial Public Offering Securities Litigation*, Civ. No. 01-9349 (SAS) (S.D.N.Y.), related to *In re Initial Public Offering Securities Litigation*, 21 MC 92 (SAS) (S.D.N.Y.). The amended complaint is brought purportedly on behalf of all persons who purchased our common stock from February 25, 1999 (the date of our initial public offering) through December 6, 2000. It names as defendants the company, three of our present and former officers and directors, and several investment banking firms that served as underwriters of our initial public offering. The complaint alleges liability under Sections 11 and 15 of the Securities Act of 1933, as amended, and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, on the grounds that the registration statement for the offerings did not disclose that: (1) the underwriters had agreed to allow certain customers to purchase shares in the offerings in exchange for excess commissions paid to the underwriters; and (2) the underwriters had arranged for certain customers to purchase additional shares in the aftermarket at predetermined prices. The amended complaint also alleges that the underwriters misused their securities analysts to manipulate the price of our stock. No specific damages are claimed.

Lawsuits containing similar allegations have been filed in the Southern District of New York challenging over 300 other initial public offerings and secondary offerings conducted in 1999 and 2000. All of these lawsuits have been consolidated for pretrial purposes before United States District Court Judge Shira Scheindlin of the Southern District of New York. On July 15, 2002, an omnibus motion to dismiss was filed in the coordinated litigation on behalf of the issuer defendants, of which the company and three of our named current and former officers and directors are a part, on common pleadings issues. On or about October 9, 2002, the Court entered and ordered a Stipulation of Dismissal, which dismissed the three named current and former officers and directors from the litigation without prejudice. On February 19, 2003, the Court entered an order denying in part the issuer-defendants' omnibus motion to dismiss, including those portions of the motion to dismiss relating to us.

In June 2004, a stipulation of settlement for the claims against the issuer-defendants, including us, was submitted to the Court. The underwriter-defendants in the *In re Initial Public Offering Securities Litigation*, including the underwriters of our initial public offering, were not parties to the stipulation of settlement.

Under the settlement, we would have been dismissed of all claims in exchange for a contingent payment guarantee by the insurance companies responsible for insuring us as an issuer. In August 2005, the Court preliminarily approved the settlement.

In December 2006, the appellate court overturned the certification of classes in the six test cases that were selected by the underwriter defendants and plaintiffs in the coordinated proceedings. We are not one of the six test cases. Because class certification was a condition of the settlement, it was unlikely that the settlement would receive final Court approval. On June 25, 2007, the Court entered an order terminating the proposed settlement based on a stipulation among the parties to the settlement. Plaintiffs have filed amended master allegations and amended complaints in the six test cases, which the defendants in those cases have moved to dismiss. It is uncertain whether there will be any revised or future settlement. If the litigation continues, then we believe that we have meritorious defenses and intend to defend the action vigorously. However, the litigation results cannot be predicted at this point.

## **NOTE 5. RELATED PARTY TRANSACTIONS**

During the nine months ended November 30, 2007, we provided e-commerce solutions to our customers by using managed e-commerce services provided by a wholly owned subsidiary of Digital River, Inc. As of December 31, 2007, Digital River, Inc. owned approximately 14% of our outstanding capital stock (on an as-converted to common stock basis). As a result of providing these solutions, we recognized an immaterial amount of revenue and related costs of revenue. All of these costs were paid to the Digital River, Inc. subsidiary.

During the three and nine months ended November 30, 2007, we purchased computer equipment and services from one of our largest customers totaling approximately \$20,000 and \$173,000, respectively.

## NOTE 6. COMMON STOCK

### Stock Based Compensation Expense

The table below reflects stock compensation expense under SFAS 123(R) for the three and nine months ended November 30, 2007 (in thousands):

	For the three months ended November 30, 2007	For the nine months ended November 30, 2007
Stock-based compensation expense by type of award		
Employee stock options and awards	\$ 127	\$ 449
Employee stock purchase plan	25	90
Increase to net loss	<u>\$ 152</u>	<u>\$ 539</u>
Effect on earnings per share: basic and diluted	\$ (0.02)	\$ (0.09)

The following table summarizes stock-based compensation expense related to employee stock options and awards, as well as employee stock purchases under the ESPP for the three and nine months ended November 30, 2007, as it was allocated in the statements of operations (in thousands):

	For the three months ended November 30, 2007		For the nine months ended November 30, 2007	
	Stock Compensation Expense	Percent of Total Expense	Stock Compensation Expense	Percent of Total Expense
Cost of revenues	\$ 12	8 %	\$ 44	8 %
Sales and marketing	29	19 %	95	18 %
Research and development	12	8 %	52	10 %
General and administrative	<u>99</u>	65 %	<u>348</u>	64 %
Total stock-based compensation	<u>\$ 152</u>		<u>\$ 539</u>	

As of November 30, 2007, we had an aggregate of 664,691 shares available for grant under our equity plans. Our equity plans provide for the issuance of our common stock pursuant to stock option exercises and other equity-based awards. Under our equity plans, equity awards can be issued to employees, non-employee directors and consultants. Stock options are generally granted under the equity plans with exercise prices equal to the fair market value of our common stock on the date of grant. There were no stock option awards granted during the three months ended November 30, 2007.

The following weighted average assumptions were used in the estimated grant date fair value calculations for stock option awards:

	For the three months ended		For the nine months ended	
	November 30, 2007	November 30, 2006	November 30, 2007	November 30, 2006
Stock option plans:				
<u>Five Year Grants:</u>				
Dividend yield	n/a	n/a	0 %	0 %
Expected stock price volatility	n/a	n/a	63 %	73 %
Risk-free interest rate	n/a	n/a	5.18 %	4.84 %
Average expected life (in years)	n/a	n/a	0.12	3.52
Weighted average grant-date fair value of options granted during the period	n/a	n/a	\$ 1.54	\$ 2.01
<u>Ten Year Grants:</u>				
Dividend yield	n/a	0 %	n/a	0 %
Expected stock price volatility	n/a	99 %	n/a	102 %
Risk-free interest rate	n/a	5.2 %	n/a	4.74 %
Average expected life (in years)	n/a	6.21	n/a	5.45
Weighted average grant-date fair value of options granted during the period	n/a	\$ 3.55	n/a	\$ 4.78

The following table presents a summary of our stock option activity for the three and nine months ended November 30, 2007 (in thousands):

	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (\$000's)
Outstanding at February 28, 2007	1,345	\$ 11.86	\$ 704
Granted	4	3.67	
Exercised	(48)	3.48	
Exchanged	(131)	7.46	
Forfeited	(119)	11.48	
Outstanding at May 31, 2007	1,051	12.30	\$ 288
Granted	-	-	
Exercised	(17)	3.66	
Forfeited	(37)	19.13	
Outstanding at August 31, 2007	997	12.20	\$ 491
Granted			
Exercised	(3)	3.46	
Forfeited	(17)	15.06	
Outstanding at November 30, 2007	977	\$ 12.18	\$ 366
Exercisable at November 30, 2007	817	\$ 13.77	\$ 205

The aggregate intrinsic value is the sum of the amounts by which the quoted market price of our stock exceeded the exercise price of the options at November 30, 2007, for those options for which the quoted market price was in excess of the exercise price. The aggregate intrinsic value of options exercised during the three months ended November 30, 2007 was approximately \$4,000. The total cash received from employees as a result of stock

option exercises for the three and nine months ended November 30, 2007 was approximately \$11,000 and \$240,000, respectively. We did not realize any tax benefits in connection with these exercises due to a full valuation allowance relating to our deferred tax assets that had previously been recorded.

The total compensation cost related to unvested stock options and awards is approximately \$1.4 million and will be recognized over a weighted average period of approximately 1.7 years.

### **Restricted Stock Units**

On March 12, 2007, we offered to certain employees the opportunity to participate in the Employee Stock Option/Restricted Stock Unit Exchange Program, which we refer to herein as the Exchange Program. Under the Exchange Program, the employees were granted the right to exchange certain eligible stock options for restricted stock units with a three year vesting schedule (one-third vest one year from the grant date and one-twelfth vest quarterly thereafter for the remaining eight quarters). The eligible stock options consisted of those unexercised and unvested stock options with an exercise price per share of \$5.00 or more. The number of restricted stock units an employee received in exchange for his or her eligible stock options was based on the number and exercise price of the eligible stock options exchanged. We adopted the Pool Approach to amortize any unrecognized compensation cost related to the original stock options over the remaining modified requisite service period. We did not record any incremental compensation expense as a result of the Exchange Program, and the compensation expense remaining on the unvested options that were exchanged for the restricted stock units will be recognized ratably over the three year vesting period of the restricted stock units.

Pursuant to the Exchange Program, which expired on April 9, 2007, we accepted for cancellation options to purchase 130,515 shares of our common stock and granted in exchange restricted stock units which represent the right to receive 52,769 shares of our common stock in the future, resulting in an overall exchange ratio of approximately 2.5 options to 1.0 restricted stock unit. Included in these figures were 98,000 options previously held by our executive officers, who received a total of 40,795 restricted stock units. We entered into a Restricted Stock Unit Agreement with each participating employee. The restricted stock units will vest over three years beginning April 9, 2007. The unrecognized compensation expense related to the unvested options that were exchanged for restricted stock units will be recognized ratably over the three year vesting period of the restricted stock units.

In addition to restricted stock units granted pursuant to the Exchange Program, we have granted restricted stock units to our non-employee independent directors that will vest over a two year period, and restricted stock units to certain newly hired and other employees that vest over a three year period. We expect to grant additional restricted stock units, rather than stock options, in future periods. We anticipate a decrease in our stock compensation expense as a result of employee stock options with higher fair values becoming fully amortized and the cancellation of certain unvested employee stock options in connection with the Exchange Program.

Restricted stock unit activity for the three and nine months ended November 30, 2007 is summarized as follows (in thousands):

	Shares	Weighted-Average Grant Date Fair Value Price
Unvested at February 28, 2007	-	\$ -
Granted	20	14.83
Exercised	-	-
Exchanged	53	18.45
Forfeited	(9)	10.61
Outstanding at May 31, 2007	64	15.43
Granted	7	5.08
Exercised	-	-
Forfeited	(1)	41.18
Outstanding at August 31, 2007	70	14.16
Granted	32	5.26
Exercised	-	-
Forfeited	-	-
Outstanding at November 30, 2007	102	\$ 11.35

#### Employee Stock Purchase Plan

On March 12, 2007, our Board of Directors approved an amendment to our ESPP, which was initially approved and adopted in December 1998 and expires in December 2008. Under the amendment, the purchase discount was reduced to 5% from 15%, and such discount was modified so that it will be applied only to the date of purchase rather than any earlier or "look-back" dates. Effective from May 1, 2007, the price at which our common stock will be purchased under our ESPP shall be 95% of the fair market value of our common stock on the last day of the applicable offering period.

#### NOTE 7. PREFERRED STOCK

We are authorized, subject to limitations prescribed by Delaware law, to provide for the issuance of preferred stock in one or more series, to establish from time to time the number of shares included within each series, to fix the rights, preferences and privileges of the shares of each wholly unissued series and any qualifications, limitations or restrictions thereon, and to increase or decrease the number of shares of any such series (but not below the number of shares of such series then outstanding) without any further vote or action by the stockholders. During the nine months ended November 30, 2007, there was no activity in our redeemable convertible preferred stock.

#### NOTE 8. SUBSEQUENT EVENT

On December 28, 2007, Drysdale Partners voluntarily converted 13,812 shares of our Series A Preferred Stock into an equivalent number of shares of our common stock, in accordance with the terms of the Series A Preferred Stock, with no additional consideration being paid in connection with the conversion. Drysdale Partners is not an officer, director or five percent (5%) shareholder of our outstanding common and preferred stock on an as-converted basis.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*The following discussion of our financial condition and results of operations should be read in conjunction with our financial statements and related notes included in our Annual Report on Form 10-K for the fiscal year ended February 28, 2007, which was filed with the SEC on April 26, 2007, and the unaudited financial statements and related notes contained in this Quarterly Report on Form 10-Q. This discussion contains forward-looking statements that involve risks and uncertainties. Forward-looking statements include statements regarding trends in the marketplace, our future cash and liquidity position, the extent and timing of future revenues, expenses and customer demand, the deployment of our products and services or the anticipated performance and application of products or services, statements regarding future economic conditions or performance, and statements regarding our anticipated interactions with third parties. All forward-looking statements included in this document are based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statement except as required by law. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including without limitation those discussed in Item 1A Risk Factors of this Quarterly Report on Form 10-Q.*

### Overview

Our goal is to become the de facto standard among digital delivery solution providers. We are pursuing various strategic objectives to achieve this goal. First, we are working to become a profitable, cash-generating company by growing our SubscribeNet service business and practicing stringent fiscal responsibility. Second, we are actively increasing our efforts to reach markets outside our existing enterprise software developer customer base. We intend to leverage our digital delivery and entitlement expertise, and expanded service offering, to penetrate new markets and new market segments. Third, we are seeking to strengthen our technological advantage and extend the breadth of our functionality in the electronic digital asset delivery and entitlement management area by further improving our central offering through internal research and development, through alliances with complementary technology providers, and through development efforts to bring new capabilities to our services to help us access new markets. We are also seeking to extend and strengthen our customer base by executing on our sales and marketing plan and providing exceptional customer service.

Our central offering is the SubscribeNet service. Our SubscribeNet service is an on-demand solution for digital asset management and delivery that enables technology companies to deliver digital files and interact with their customers in an efficient and controlled manner. Our traditional market for the SubscribeNet service has been enterprise technology companies. Our SubscribeNet service allows software providers and their channel partners to distribute software online, manage licensing and entitlement across their global customer bases, track and report deliveries and download activity, and manage export compliance. By using the SubscribeNet service, customers can reduce their costs associated with manufacturing, packaging and distributing physical CDs, and automate and simplify their software licensing processes. SubscribeNet also enhances export and revenue recognition compliance.

We believe the SubscribeNet service also has broad application beyond the enterprise technology industry, including the delivery and entitlement management of digital goods such as video, music, and content. Accordingly, we are expanding our efforts to reach these new markets. One market of particular interest to us is video delivery. We believe our technology is well suited to digital entertainment distribution because we have the ability to store and deliver large files at high speeds, and a unique system of entitlement controls to prevent unauthorized downloads of valuable digital content. We believe this technology has applications both for enterprises and individuals. We also see similar opportunities for the delivery and management of music, game files and various forms of digital media.

During our 2006 fiscal year, we launched Digital Fastball, an electronic content delivery and management service designed for small and medium-sized business professionals. Our Digital Fastball service uses our network to provide users a fast and secure means of controlling ongoing access of their valuable digital content to a specified list of recipients across the globe. The underlying technology and infrastructure is based upon our SubscribeNet technology, which our customers use for electronic software delivery and management. We currently are offering Digital Fastball as a free service to establish a user community and generate word-of-mouth marketing. We also are



exploring opportunities to deliver and manage video and digital content in new markets, including social networking, and are investing resources toward this end. In the longer term, we intend to develop and market related product offerings on a revenue-generating basis in targeted industries where the need for entitlement controls and large file delivery is greatest.

During the three months ended November 30, 2007, we launched the beta version of our zAthlete social networking site. zAthlete is an online social network dedicated to athletes. The site was launched to provide exposure for athletes and enable them to share video, pictures, statistics and more. We intend to further develop the site leveraging our knowledge in the management and distribution of digital content. In the future we intend to seek to generate advertising revenues and other revenues from this site.

We earn revenues and generate cash principally through recurring service fees charged for our SubscribeNet service and professional services fees charged for the customization of our SubscribeNet service. We have not, to date, generated any significant revenues from our Digital Fastball service or our zAthlete social networking site. There can be no assurance that either will ever generate significant revenue.

We have incurred losses from operations during each fiscal year since inception and have incurred negative cash flows from operations during each fiscal year since inception, with the exception of our most recent fiscal year ended February 28, 2007. Net loss for the nine months ended November 30, 2007 decreased from our prior year loss for the corresponding period. We recorded net income for the three months ended November 30, 2007 of approximately \$0.1 million. For the nine months ended November 30, 2007, we recorded cash provided by operating activities of approximately \$0.1 million, which was a slight increase from cash provided by operations from the corresponding period in the prior year. Our cash flow position for the current quarter is discussed further in the "**Liquidity and Capital Resources**" section below.

We believe that the effects of our capital financings to date, our past and current strategic actions to improve revenue, and our ongoing cost controls will generate sufficient cash resources to fund our future operations. However, if we fail to adequately increase our revenues or control spending, our business could suffer material adverse effects.

We face a number of risks that are described in more detail in **Item 1A. Risk Factors** below.

### *Important Trends*

We currently see a number of trends in the marketplace that are important for our business. Perhaps the most significant trend is the increasing role our electronic licensing delivery service is playing in our business, which over the past two years has become at least as important as our electronic software delivery services. In most respects, this has been a positive development for us. For example, the typical contract value for our license solution is often higher than that of electronic software delivery, and it has gained market acceptance over a shorter period of time than electronic software delivery, which may suggest that the service addresses a more critical and immediate problem for our potential customers. We also believe our software-as-a-service model gives us a competitive advantage relative to our major competitors because we can usually offer customers delivery and entitlement management services more quickly, and at less cost, than if they purchase an installed software application that requires a significant license fee and extensive professional services work.

The shift toward our licensing solution also carries risks, however, because sales of our licensing service involve more complex implementations and more professional services work than sales of our other services. Thus, while we believe our licensing solution requires substantially less professional services work than the installed software applications sold by our competitors, our implementations of the licensing service have taken longer and been more challenging than implementations of our software delivery services. Consequently, it has taken substantially more time for us to recognize revenue from these contracts. Moreover, the increased emphasis on our licensing solution has played a major role in increasing the percentage of our revenues that are derived from professional services. Unlike our recurring subscription fees, which are relatively predictable and have favorable profit margins, professional services revenues are neither recurring nor predictable quarter over quarter, and they often carry lower profit margins. Over time, we expect to gain efficiencies in our licensing service implementations as we continue to build repeatable processes and learn from implementations we have already performed. For the

foreseeable future, however, we face risks that our growing dependence on our licensing solution could delay our ability to recognize revenue, negatively impact our profit margins, and make it more difficult to accurately forecast our future results. If some or all of these challenges continue or worsen, our business operations and results could suffer.

Another ongoing trend affecting us is the pace of mergers and acquisitions in the enterprise software sector. These consolidations pose both opportunities and risks for us, potentially leading either to growth in our contracts with customers who grow larger, or to cancellation of customer contracts by customers who merge or are acquired by companies that do not use our SubscribeNet service.

One trend that has become more prevalent over the past year, and which we expect to continue, is an increase in variable billing provisions in our customer agreements. Typically, these variable billing terms provide that a portion of customer fees will be based upon the number of transactions the customer processes through our SubscribeNet service. In large part, we attribute this increase in variable billing to our penetration of markets outside the traditional enterprise software sector, and to our agreements with large digital distributors who have contracted with us to process their deliveries. We believe these agreements have been beneficial to us, but the trend toward variable billings carries the risk that our future revenues will be less stable and predictable.

In addition, we see a number of sustained trends in the enterprise software sector. For example, technology companies continue moving toward outsourcing operational functions to reduce costs. Our services enable enterprise software companies to outsource key operational functions in a manner that we believe is financially compelling. Therefore, we may benefit from this trend on an ongoing basis. Hosted web-based applications, which in the past have been limited by concerns about speed, reliability and security, continue to gain acceptance among mainstream businesses, largely because of the cost savings they can offer. This trend may benefit us as our SubscribeNet service is a hosted web-based application.

### **Critical Accounting Policies and Estimates**

In this Management's Discussion and Analysis of Financial Condition and Results of Operations, we discuss our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. In preparing these financial statements, we are required to make estimates and assumptions affecting the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. We evaluate our estimates and judgments on an ongoing basis. We base our estimates and judgments on historical experience and on various other factors we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities not readily apparent from other sources. Actual results may differ from these estimates.

We consider accounting policies related to revenue recognition, costs of deferred revenue, stock-based compensation, allowance for doubtful accounts, and income taxes to be critical accounting policies due to the estimation process involved in each.

#### *Revenue Recognition*

We recognize revenue when all of the following conditions are met:

- There is persuasive evidence of an arrangement;
- We have provided the service to the customer, made the software available for customer download through our website, or shipped the software to the customer;
- We believe collection of fees is reasonably assured; and
- The amount of fees to be paid by the customer is fixed or determinable.

Our revenue results primarily from three types of arrangements: (1) sales of our SubscribeNet digital delivery service to software vendors and other companies that distribute software as part of their business; (2) professional services to such customers in connection with customization of our SubscribeNet service, data conversion, and integration of our SubscribeNet service with other third party software; and (3) resale of third-party services or licenses complementary to our SubscribeNet service, including e-commerce. In addition, if appropriate opportunities present themselves in the future, we may generate revenue from the licenses of our proprietary software, along with related maintenance, to companies using our software internally or to provide web-based services to their customers.

We defer revenues related to our SubscribeNet service and generally recognize them ratably over the term of the service arrangement. The typical subscription term is one year, although some may be shorter or extend up to three years. Our SubscribeNet service agreements are generally noncancelable, although customers usually have the right to terminate for cause if we materially fail to perform. A majority of our SubscribeNet service implementations for new customers involve customization essential to the functionality of the service. In these cases, we defer revenue recognition until the service go-live date and then recognize the SubscribeNet service revenue ratably over the remaining contract term. The go-live date is the later of the customer acceptance date or the point at which no additional customization is required. If the implementation fee is bundled with the recurring SubscribeNet service fee, it is recognized over the same period as the SubscribeNet service fee. If the implementation fee is charged separately, then the associated revenue is recognized in accordance with our professional services revenue recognition policy, described below. Our SubscribeNet service agreements normally provide a set period (generally five days) for a customer to evaluate a completed implementation, and also provide for deemed acceptance if the customer has not affirmatively rejected the implementation within such period. We typically rely on such deemed acceptance by most of our customers.

As stated above, in addition to implementations, we also provide other professional services to our customers related to our SubscribeNet agreements. Generally, these services do not provide stand-alone value to a customer. We defer recognition of this revenue until the go-live date for the professional services, similar to the manner in which we treat SubscribeNet service revenues discussed above. Such professional services revenues are recognized ratably over the longer of the remaining estimated customer life or the remaining contract term, commencing with the acceptance of the professional services. In some instances, the fees related to the implementation of the SubscribeNet service and other professional services are bundled with the SubscribeNet service fee without specifically stating the fees attributable to each portion of the services. In these instances, the professional services fees are recognized from acceptance of the professional services through the end of the remaining contract term on a ratable basis with the SubscribeNet service fee.

Revenues related to our resale of third-party services or software licenses complementary to our SubscribeNet service are generally recognized as the service or license is provided. If the resold service or license involves customization essential to the functionality of the service or software license, the fees charged for the customization are recognized as revenue in the same manner as professional services discussed above. Resold services or licenses are recognized as revenue based on the gross fee charged to the customer, since we bear the credit risk for resold services or licenses, have latitude in establishing pricing, and are primarily responsible for acceptability of the services or licenses delivered. In addition, costs paid to the third-party providers are recorded as cost of revenues and recognized over the same period as the related revenue.

We also recognize revenues related to variable billings of the SubscribeNet service for certain existing customers. When such customers exceed their maximum commitment levels for specified SubscribeNet service metrics in any given period, the associated revenues are recognized according to the provisions specified for such overages.

#### *Deferred Costs*

We capitalize direct costs of revenues related to significant SubscribeNet service implementations and established professional services contracts associated with our SubscribeNet services. Direct costs include compensation and payroll-related benefits directly related to the time spent on significant implementation and professional services activities. These costs are recognized over the same period as related revenue is recognized (see *Revenue Recognition* above). Costs associated with professional services involving significant new

functionality for the SubscribeNet service that are partially or fully funded by customers, but which do not qualify as funded research and development activities, are expensed as costs of revenues as incurred until a working model is delivered to the customer. Once a working model has been delivered, all additional direct costs are capitalized in the same manner discussed above.

Estimated customer life requires that we periodically estimate the projected life of our existing customers based on historical information such as customer renewal rates. Any changes in our estimated customer life estimates could result in corresponding changes to our recognition of deferred revenues and costs. A 10% increase in our estimated customer life during the three and nine months ended November 30, 2007 would have caused a decrease in the amortization of both deferred revenues and deferred costs of revenues, resulting in an immaterial decrease to our net income and an immaterial increase to our net loss, respectively. At November 30, 2007, we had approximately \$0.8 million in capitalized costs relating to deferred revenues. We expense customer acquisition costs, including sales commissions, as incurred.

We also defer legal costs incurred in connection with patent applications. As of November 30, 2007, we had approximately \$0.2 million in deferred legal costs related to patent applications. Upon issuance of a patent, the deferred legal costs for that patent are expensed ratably over the patent's estimated useful life.

#### *Stock-based Compensation*

Following the guidance prescribed in SAB 107, on March 1, 2006 we adopted SFAS 123(R) using the modified prospective method and, accordingly, have not restated the results of income from prior interim periods and fiscal years. Under SFAS 123(R), we measure compensation cost for all stock-based awards at fair value on the date of grant and recognize compensation expense on a straight-line basis over the service period that the awards are expected to vest. Stock options and awards issued under our equity plans as well as stock purchases under our ESPP are subject to SFAS 123(R). Stock options and awards issued under our equity plans generally vest over a three to four-year service period. We adopted and implemented our 2006 Equity Incentive Plan during our fiscal year ended February 28, 2007. See our Annual Report on Form 10-K for our fiscal year ended February 28, 2007 for further discussion on our 2006 Equity Incentive Plan.

#### *Software Development Costs*

We account for costs incurred for computer software developed or obtained for internal use in accordance with SOP 98-1. SOP 98-1 requires companies to capitalize qualifying computer software costs that are incurred during the application and development stage and amortize them over the software's estimated useful life.

We capitalized approximately \$177,000 and \$354,000 in internal use software costs during the three and nine months ended November 30, 2007, respectively, compared to approximately \$52,000 and \$139,000 for the three and nine months ended November 30, 2006, respectively. A portion of the software is still in the development stage and was not placed into service as of November 30, 2007. We will cease capitalizing the internal use software development costs when the software is used to perform the function intended and technological feasibility has been determined. These associated costs will then be amortized using the straight-line method over the estimated useful life of the software, which is generally three years. We will continue to capitalize development costs on existing software in those instances in which the development results in additional functionality.

#### *Allowance for Doubtful Accounts*

We maintain an allowance for doubtful accounts for estimated losses from our inability to collect required payments from our customers. When evaluating the adequacy of this allowance, we analyze specific accounts receivable, historical bad debts, customer credit-worthiness, current economic trends and changes in our customers' payment history. We may need to record increases to our allowance balances in the future. Any dispute, early contract termination, or other collection issue related to these receivable balances could have a material adverse impact on our financial condition or results of operations. There were no allowances made during the nine months ended November 30, 2007.

## *Income Taxes*

In conjunction with preparing our financial statements, we must estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax expense together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income. To the extent we believe that recovery is not likely, we must establish a valuation allowance. Since we have incurred losses since inception and therefore have not been required to pay income taxes, we have fully reserved our deferred tax assets at November 30, 2007. In the event we are able to realize our deferred tax assets in the future, adjustments to the deferred tax assets would increase income or decrease losses in the period in which they are realized.

## **Results of Operations**

### *Total Revenue*

The following table sets forth the revenue and change in revenue for the periods indicated (in thousands):

For the three months ended				For the nine months ended		
November 30, 2007		November 30, 2006	November 30, 2007		November 30, 2006	
Total	Change	Total	Total	Change	Total	
Revenue	\$ 3,118	\$ 315	\$ 2,803	\$ 9,048	\$ 1,050	\$ 7,998

The increase in revenue during the three months ended November 30, 2007, compared to the three months ended November 30, 2006, is primarily due to approximately \$370,000 in revenue that was recognized from new SubscribeNet service customers whose go-live date was achieved between September 1, 2006, and November 30, 2007 and a net increase of approximately \$230,000 related to professional services, increases in contract values and variable billings for existing customers. These increases were partially offset by a decrease of approximately \$285,000 related to customers who terminated their contracts during the last 12 months.

The increase in revenue during the nine months ended November 30, 2007, compared to the nine months ended November 30, 2006, is primarily due to approximately \$1,380,000 in revenue that was recognized from new SubscribeNet service customers whose go-live date was achieved between March 1, 2006, and November 30, 2007, recognition of approximately \$270,000 of deferred revenue from a customer who terminated its agreement during the period, and a net increase of approximately \$490,000 related to professional services, increases in contract values and variable billings for existing customers. These increases were partially offset by a decrease of approximately \$1,090,000 related to customers who terminated their contracts during the last 12 months.

Because of a customer termination we anticipate to occur during our fourth quarter ending February 29, 2008, we expect our revenue to slightly decrease from our third quarter, which ended November 30, 2007.

## Costs and Expenses

The following table sets forth the costs and expenses, changes in costs and expenses, and percentage of total revenue for the periods indicated (in thousands, except percentage amounts):

	For the three months ended					For the nine months ended				
	November 30, 2007			November 30, 2006		November 30, 2007			November 30, 2006	
	Total	Change	% of Revenue	Total	% of Revenue	Total	Change	% of Revenue	Total	% of Revenue
Total cost of revenues	\$ 1,079	\$ (293)	35%	\$ 1,372	49%	\$ 3,176	\$ (344)	35%	\$ 3,520	44%
Gross margin	2,039	608	65%	1,431	51%	5,872	1,394	65%	4,478	56%
Operating expenses:										
Sales and marketing	676	(177)	22%	853	30%	1,987	(340)	22%	2,327	29%
Product development	343	15	11%	328	12%	1,117	(192)	12%	1,309	16%
General and administrative	1,087	5	35%	1,082	39%	3,435	10	38%	3,425	43%
Loss (gain) on disposal of assets	(1)	(1)	0%	-		25	25	0%	-	
Total operating expenses	\$ 2,105	\$ (158)	68%	\$ 2,263	81%	\$ 6,564	\$ (497)	73%	\$ 7,061	88%

## Cost of Revenues

Our cost of revenues for the three and nine months ended November 30, 2007 decreased from the prior year results. The decrease was due to lower allocated costs during the three months ended November 30, 2007 related to direct employee expenses as personnel spent time on activities not directly related to cost of revenues. The decrease is also attributable to unusual events which occurred during the three months ended November 30, 2006, including approximately \$0.1 million related to stock based compensation expense that was related to prior periods and approximately \$0.1 million related to a payment for the termination of an e-commerce agreement. The increase in the gross profit margin percentage for the three and nine months ended November 30, 2007 is primarily due to increased revenue while reducing total cost of revenues.

Cost of revenues primarily consists of certain allocated costs related to our internet connectivity, assets supporting cost of revenues, and customer support. Cost of revenues also consists of professional services personnel costs and the cost of third-party products and services sold. We expect total cost of revenues for the current fiscal year to be slightly lower than fiscal year 2007 due to a reduction in allocated personnel expenses and slightly lower infrastructure costs. In addition, we expect our gross profit margin percentage for the current fiscal year to increase from our fiscal year 2007 levels as our total revenues increase at a higher rate than our costs of revenues. Our quarterly cost of revenues may fluctuate based on multiple variables including, without limitation, revenue mix fluctuations, levels of professional services activities, infrastructure costs, and variable external support utilization rates. We expect our gross profit margins for our fiscal year 2008 to be approximately 65%.

## Sales and Marketing Expenses

Sales and marketing expenses consist primarily of employee salaries, benefits and commissions, as well as advertising, promotional materials and trade show expenses.

Our sales and marketing expenses for the three and nine months ended November 30, 2007 decreased approximately \$177,000 and \$340,000, respectively, compared to prior year results for the corresponding periods. The decrease was the result of lower expenses primarily related to personnel costs, including salaries, sales commissions, stock based compensation and recruiting fees. These decreases were the result of a reduction in forces that occurred in February 2007. There was also a decrease in employee time allocated to sales and marketing activities. For the reasons discussed in this paragraph we expect our sales and marketing expenses in our fiscal year ending February 29, 2008 to decrease from our expenses in our fiscal year ended February 28, 2007.

### *Product Development Expenses*

Product development expenses primarily consist of personnel, consulting, software and related maintenance, equipment depreciation expense and allocated overhead costs. Costs related to research, design and development of products and services have been charged to product development expense as incurred.

Our product development expense for the three months ended November 30, 2007 was fairly consistent with the product development expenses related to the prior year results for the corresponding period.

Our product development expense for the nine months ended November 30, 2007 decreased approximately \$192,000, compared to the prior year results for the corresponding period. The decrease was primarily due to a reduction in expenses allocated to product development activities as personnel increased time spent on capitalizable product development activities, a decrease in personnel costs related to operations management and decreases in variable support costs and incremental investments in our infrastructure related to product development activities.

We anticipate continued investment in additional functionality for our SubscribeNet service, our underlying proprietary software, and new services related to our software such as our zAthlete social networking site. We expect those investments to fluctuate over time and therefore expect our product development expenses to vary accordingly. However, we expect total product development expenditures in our fiscal year ending February 29, 2008 to decrease from such expenditures during our fiscal year ended February 28, 2007.

### *General and Administrative Expenses*

General and administrative expenses consist primarily of compensation for administrative and executive personnel, fees for professional services and certain overhead costs.

General and administrative expenses for the three and nine months ended November 30, 2007 remained fairly consistent with the prior year results for the corresponding periods.

We expect total general and administrative expenditures in fiscal year 2008 to decrease from our fiscal year 2007 levels due primarily to an expected decrease in stock compensation expense. Stock compensation expense is expected to decrease as employee stock options become fully amortized and due to certain unvested employee stock options that were cancelled as part of the Exchange Program described in Note 6 to our financial statements, **“Common Stock.”**

### *Gain (Loss) on Disposal of Assets*

For the three and nine months ended November 30, 2007, we recognized a gain of approximately \$1,000 and a loss of approximately \$25,000 for the disposal of assets, respectively. During the nine months ended November 30, 2007 there was a loss on the disposal of an asset related to computer software that is no longer being utilized which accounted for an approximate loss of \$22,000.

### *Interest Expense*

For the three and nine months ended November 30, 2007, we incurred no interest expense, a decrease of \$9,000 and \$30,000 from the three and nine months ended November 30, 2006, respectively. As of November 30, 2007, we have no outstanding debt or capital lease obligations, and accordingly, we do not expect to incur any interest expense for the fiscal year ending February 29, 2008.

### *Interest and Other Income*

For the three months ended November 30, 2007, interest and other income was approximately \$144,000 of income, a slight decrease from \$147,000 for the three months ended November 30, 2006. For the nine months ended November 30, 2007, interest and other income was approximately \$446,000 of income, a decrease from \$581,000 for the nine months ended November 30, 2006. The decrease in interest and other income for the nine months ended November 30, 2007 was primarily due to a one-time litigation settlement that we received in the amount of

\$152,366 during the nine months ended November 30, 2006. On an ongoing basis, interest and other income primarily relates to interest earned on our investment balances.

### *Income Taxes*

As of February 28, 2007, we had approximately \$25 million of federal and \$12.6 million of state net operating loss carryforwards available to offset future taxable income, which will expire at various dates between 2017 and 2027. The Tax Reform Act of 1986 limits the use of net operating losses and tax credit carryforwards in certain circumstances where changes occur in the stock ownership of a company. Because of cumulative ownership changes in the past, the federal and state loss carryforwards have been reduced by the amount of the net operating loss carryforwards that will expire. Should there be a future change of ownership, the available net operating losses may be further limited. Based upon our limited operating history and losses incurred to date, management does not believe the realization of the related deferred tax assets meets the recognition criteria required by generally accepted accounting principles and accordingly, a full valuation allowance has been recorded to reduce the carrying value of the deferred tax assets to zero.

### **Liquidity and Capital Resources**

The following table presents our liquidity position at November 30, 2007 and 2006 (in thousands):

	For the nine months ended	
	November 30, 2007	November 30, 2006
Cash and cash equivalents	\$ 12,279	\$ 12,337
Working capital	\$ 10,426	\$ 10,402
Net cash provided by operating activities	\$ 88	\$ 69
Net cash provided by (used in) financing activities	\$ 374	\$ (130)
Net cash used in investing activities	\$ (443)	\$ (252)

We had \$12.3 million in cash and cash equivalents at November 30, 2007 and our working capital was \$10.4 million.

Our net cash provided by operations was approximately \$88,000 for the nine months ended November 30, 2007, which was a slight increase from the cash provided by operations during the nine months ended November 30, 2006. Our positive operating cash flow was primarily due to our income excluding non-cash stock-based compensation charges as well as an ongoing effort to improve collection rates on all outstanding receivables. Our ability to generate positive cash flows in future periods will largely depend on our ability to increase the number of customers of our SubscribeNet service while increasing existing subscriptions through strong contract renewals. We expect our cash balances to fluctuate from time to time due to the timing of customer collections and vendor payments in the ordinary course of business.

Our net cash provided by financing activities was approximately \$374,000 for the nine months ended November 30, 2007. This amount was the result of proceeds from the issuance of approximately 102,000 shares of common stock in connection with our stock option plan and our ESPP.

Our net cash used in investing activities was approximately \$443,000 during the nine months ended November 30, 2007. This amount was comprised of our purchases of fixed assets paid from our cash and cash equivalents and capitalized costs related to the development of internal use software. We used these fixed asset purchases primarily to upgrade and expand our SubscribeNet service infrastructure and corporate information systems, as well as launch the beta version of our zAthlete social networking site.

We believe our existing cash and cash equivalents, together with any cash generated from future operations, will be sufficient to fund our operating activities, capital expenditures and financing arrangements for the foreseeable future. If we fail to generate sufficient revenues or adequately control spending, we may be unable to achieve key business objectives.



At November 30, 2007, we had no relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

The following table summarizes our lease obligations and contractual commitments at November 30, 2007, and the effect such obligations are expected to have on our liquidity and cash flow in future periods (in thousands). This table provides information through our fiscal year ending February 28, 2012, as we do not have any debt or lease obligations beyond that point.

	Payments due by period		
	Total	Less than 1 Year (a)	1-4 years (b)
Operating leases	\$ 942	\$ 134	\$ 808
Contractual commitments	1,490	370	1,120
	<u>\$ 2,432</u>	<u>\$ 504</u>	<u>\$ 1,928</u>

(a) Includes payments from December 1, 2007 through February 29, 2008.

(b) Includes payments from March 1, 2008 through February 28, 2012.

As of November 30, 2007, our Series A and Series B redeemable convertible preferred stock entitled the holders to liquidation preferences of a minimum of \$0.5 million and \$6.0 million (or, if greater, the aggregate value of the common stock into which the Series B convertible preferred stock is then convertible), respectively, in the event of deemed liquidation events with respect to our company.

### Recent Accounting Pronouncements

We are currently evaluating the impact of adopting SFAS 157 on our financial position, results of operations, and cash flows; see Note 2 to our financial statements, "Significant Accounting Policies."

Our adoption of FIN 48 on March 1, 2007 has not had a significant impact on our financial position or results of operations; see Note 2 to our financial statements, "Significant Accounting Policies."

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

At November 30, 2007, we had cash and cash equivalents of \$12.3 million. We place our investments with high quality issuers, according to our investment policy, in an effort to limit the amount of credit exposure to any one issue or issuer.

Our exposure to market risk for changes in interest rates relates primarily to our cash and cash equivalents portfolio. We did not use derivative financial instruments during fiscal 2007 or the nine months ended November 30, 2007. The effect of changes in interest rates of +/- 50 basis points over a six-month horizon would not materially affect the fair value of our portfolio. Declines in interest rates will, over time, decrease the interest income from our portfolio.

### ITEM 4. CONTROLS AND PROCEDURES

(a) *Evaluation of Disclosure Controls and Procedures.* Our management, with the participation of our principal executive officer and principal financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 as amended or the Exchange Act) as of the end of the period covered by this Quarterly Report, have concluded that our disclosure controls and procedures are effective based on their evaluation of our disclosure controls and procedures required by paragraph (b) of the Exchange Act Rules 13a-15 or 15d-15.

(b) *Changes in Internal Controls over Financial Reporting.* No changes in our internal controls over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

## PART II-OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

#### *In re Intraware, Inc. Initial Public Offering Securities Litigation*

In October 2001, we were served with a summons and complaint in a purported securities class action lawsuit. On or about April 19, 2002, we were served with an amended complaint in this action, which is now titled *In re Intraware, Inc. Initial Public Offering Securities Litigation*, Civ. No. 01-9349 (SAS) (S.D.N.Y.), related to *In re Initial Public Offering Securities Litigation*, 21 MC 92 (SAS) (S.D.N.Y.). The amended complaint is brought purportedly on behalf of all persons who purchased our common stock from February 25, 1999 (the date of our initial public offering) through December 6, 2000. It names as defendants the company, three of our present and former officers and directors, and several investment banking firms that served as underwriters of our initial public offering. The complaint alleges liability under Sections 11 and 15 of the Securities Act of 1933, as amended, and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, on the grounds that the registration statement for the offerings did not disclose that: (1) the underwriters had agreed to allow certain customers to purchase shares in the offerings in exchange for excess commissions paid to the underwriters; and (2) the underwriters had arranged for certain customers to purchase additional shares in the aftermarket at predetermined prices. The amended complaint also alleges that the underwriters misused their securities analysts to manipulate the price of our stock. No specific damages are claimed.

Lawsuits containing similar allegations have been filed in the Southern District of New York challenging over 300 other initial public offerings and secondary offerings conducted in 1999 and 2000. All of these lawsuits have been consolidated for pretrial purposes before United States District Court Judge Shira Scheindlin of the Southern District of New York. On July 15, 2002, an omnibus motion to dismiss was filed in the coordinated litigation on behalf of the issuer defendants, of which the company and three of our named current and former officers and directors are a part, on common pleadings issues. On or about October 9, 2002, the Court entered and ordered a Stipulation of Dismissal, which dismissed the three named current and former officers and directors from the litigation without prejudice. On February 19, 2003, the Court entered an order denying in part the issuer-defendants' omnibus motion to dismiss, including those portions of the motion to dismiss relating to us.

In June 2004, a stipulation of settlement for the claims against the issuer-defendants, including us, was submitted to the Court. The underwriter-defendants in the *In re Initial Public Offering Securities Litigation*, including the underwriters of our initial public offering, were not parties to the stipulation of settlement.

Under the settlement, we would have been dismissed of all claims in exchange for a contingent payment guarantee by the insurance companies responsible for insuring us as an issuer. In August 2005, the Court preliminarily approved the settlement.

In December 2006, the appellate court overturned the certification of classes in the six test cases that were selected by the underwriter defendants and plaintiffs in the coordinated proceedings. We are not one of the six test cases. Because class certification was a condition of the settlement, it was unlikely that the settlement would receive final Court approval. On June 25, 2007, the Court entered an order terminating the proposed settlement based on a stipulation among the parties to the settlement. Plaintiffs have filed amended master allegations and amended complaints in the six test cases, which the defendants in those cases have moved to dismiss. It is uncertain whether there will be any revised or future settlement. If the litigation continues, then we believe that we have meritorious defenses and intend to defend the action vigorously. However, the litigation results cannot be predicted at this point.

## ITEM 1A. RISK FACTORS

*A description of the risk factors associated with our business is set forth below. This description includes any material changes to and supersedes the description of the risk factors associated with our business previously disclosed in our Annual Report on Form 10-K for the fiscal year ended February 28, 2007. You should carefully consider all of these risk factors, taken as a whole, together with the other information contained in this Quarterly Report on Form 10-Q, our Annual Report on Form 10-K for the fiscal year ended February 28, 2007 and in our other public filings. If any of the risks and uncertainties described in such risk factors actually occur, our business, financial condition or operating results could differ materially from the plans, projections and other forward-looking statements included in the section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in this report and in our other public filings. In addition, if any of the risks and uncertainties described in the following risk factors, or if any other risks and uncertainties actually occur, our business, financial condition or operating results could be harmed substantially.*

### **We have a history of losses and negative cash flow, and we have yet to achieve sustained profitability or positive cash flow.**

We have incurred significant losses since we were formed in 1996, totaling approximately \$162 million, and have yet to achieve sustained profitability or positive cash flow. Also, with the exception of a few quarters, we have not achieved positive cash flow from operations since our formation in 1996. We may not have positive cash flows from operations for our 2008 fiscal year. We cannot predict whether or when we will be able to achieve sustained profitability or positive cash flow in the future.

### **The market for our SubscribeNet service is not fully developed and remains volatile. If the market for our service does not fully develop, or develops more slowly than we expect, our business will be harmed.**

The market for on-demand digital asset delivery and management services is relatively unproven, and it is uncertain whether these services will achieve and sustain high levels of demand and market acceptance. Our success will depend to a substantial extent on the willingness of companies, large and small, to increase their use of on-demand digital delivery services. If companies do not increase their use of on-demand digital asset delivery and management services, our operating results will suffer. In addition, in this unproven market, we have limited insight into trends that may develop and affect our business. We may make errors in predicting and reacting to relevant business trends, which could harm our business. Ultimately, and particularly as the number of enterprise software companies decreases, the size of this market may be limited.

We market our SubscribeNet service principally to technology companies. However, many software companies have invested substantial personnel and financial resources in developing their own electronic software and/or license delivery systems and therefore may be unwilling to migrate to and pay for an outsourced service. In addition, some software companies have adopted automatic update, or "phone home," technology for delivering software updates, whereby an end-user's computer automatically contacts the software company's server to check whether updates are available and, if applicable, downloads and installs those updates. While SubscribeNet supports such an approach, this method for delivering software updates could be viewed by our potential and existing customers as an alternative to our digital delivery technology, and therefore any increased adoption of this automatic update technology could hurt our business and results of operations. Further, some companies may be reluctant to use our SubscribeNet delivery services because they are concerned about the security capabilities of these services.

### **The markets for our Digital Fastball service and zAthlete social networking site are unproven.**

We continue to develop our Digital Fastball service to enable small and medium-sized businesses, as well as consumers, to send, receive and manage many types and sizes of digital files over the Internet quickly, easily and securely. We currently offer the Digital Fastball service at no charge, but are working on strategic initiatives to generate Digital Fastball revenue. However, many systems are already available for sharing files over the Internet, in some cases at little or no cost. In addition, some such systems have been the targets of widely publicized litigation by copyright holders, which may make some companies reluctant to use Internet-based digital delivery services such as Digital Fastball or any related products and services that we offer in the future.

Further, we recently launched a beta version of our zAthlete social networking site. zAthlete is an online social network dedicated to athletes that allows them to share videos, pictures, statistics and more. It leverages our knowledge in the management and distribution of digital content. We anticipate seeking to generate advertising and other revenues from the site in the future, but have not generated any revenues from the site. We do not have experience in developing or marketing social networking sites. Our efforts could require significant resources, additional personnel and divert our attention from our other businesses. The size of the market for zAthlete or similar social networks is unclear and there is no assurance that we will achieve market share. There are numerous competitors in this area, with greater resources, more experience, more established commercial relationships and significantly greater name recognition than us, and we may not be able to compete effectively. In addition, to the extent that zAthlete raises privacy issues that are not fully addressed, our business and reputation could suffer.

If our development, marketing and operation of Digital Fastball, zAthlete or other related products or services prove unsuccessful, we may not generate significant revenues, profits or even a return of our investment in the upcoming fiscal year or ever, our business would suffer.

**Our efforts to enter new markets could prove unsuccessful. Conversely, we may be ill-equipped to handle growth rates that could result from entering new markets.**

We believe our SubscribeNet service also has broad application beyond the enterprise technology industry, including the delivery and entitlement management of digital goods such as video, music, and content. Accordingly, we are expanding our efforts to reach these new markets. Markets of particular interest to us include video delivery and social networking. We are currently investing resources and developing services for certain of these markets. We also see opportunities for the delivery and management of music, game files and various forms of digital media. However, we have no significant experience selling into or serving these markets, and it is possible our efforts to enter these markets will prove unsuccessful. Similarly, it is possible our efforts to develop our service to meet the needs of these new markets will not succeed. In either case, we may fail to generate revenue from these efforts, or even recover our marketing and development investments, in which case our business would likely suffer.

By contrast, if we succeed in penetrating new markets, we could face another set of problems. We are staffed to support the growth rates we foresee in our traditional enterprise software market. It is possible that if we are effective in reaching new markets, we will be inadequately staffed to service both new and existing customers at the levels we have committed to provide. It also is possible we will be unable to increase our staffing quickly enough, or manage growth effectively enough, to maintain necessary service levels and/or to pursue new opportunities as they arise, in which case our business could suffer.

**Competition from other electronic delivery and licensing providers, and potential customer development of in-house electronic delivery and/or licensing systems, could limit our revenue growth and reduce our gross margins.**

The market for selling electronic delivery and licensing services is highly competitive. Some of our competitors have longer operating histories, greater financial, technical, marketing and other resources, broader product and service offerings, better name recognition, and a larger installed base of customers than we do. Some of our competitors also have well-established relationships with our potential customers and with third party information technology or consulting firms that help market our competitors' services. We expect competition to intensify as current competitors expand and improve their service offerings and new competitors enter the market. In addition, our current and potential customers are primarily information technology companies with strong software development expertise. When considering their alternatives for implementing a system for electronic delivery of software or license keys, these companies sometimes elect to develop such systems in-house. While we believe our competitive position is strong against both external competitors and in-house development, we have at times experienced reduced prices, reduced gross margins and lost sales as a result of such competitive factors. Such competition is likely to intensify, which could limit the growth of our revenues and gross margins.

**The loss of one or more of our key customers could cause our revenue growth to slow or cause our revenues to decline.**

A substantial portion of the revenues from our SubscribeNet service comes from a relatively small number of customers. Our contracts with most of these customers are subject to renewal or cancellation annually. If any of these customers elected to cancel their agreements with us, or are acquired by companies that do not wish to use our services, our revenue growth would likely slow and our revenues could decline.

**Mergers and acquisitions in the technology sector could harm us by causing cancellation of customer contracts where our customers are acquired, or by strengthening our competitors.**

In recent years, there has been an increase in mergers and acquisitions among technology companies. This trend poses risks for us. Since our customers are technology companies, any acquisitions of our customers could lead to cancellation of our contracts with those customers by the acquiring companies. In addition, since our competitors are also technology companies, any acquisitions of other companies by our competitors, or acquisitions of our competitors by other companies, are likely to result in larger and stronger companies competing against us. Either of these types of events could reduce our revenue through loss of existing customers, or reduce our margins through increased price competition.

**Our current strategy includes the use of strategic marketing relationships, which may prove unsuccessful.**

We currently have marketing relationships in place with vendors including Digital River, Inc. and On Demand Delivery, Inc. dba Nexstra. In addition, we have marketing relationships with vendors who are members of our Preferred Rights Management Partner Program. We also have reseller relationships with Akamai Technologies, Inc. and Aspera, Inc., under which we resell their services to our SubscribeNet customers. However, our marketing relationships have yet to produce significant revenue, and if they fail to do so in the future, our business could suffer. Similarly, a deterioration or termination of our reseller relationship with Akamai could harm our business since a portion of our customer base relies on the Akamai service today.

**Although our subscription-based sales model for our SubscribeNet service limits the volatility of our online services and technology revenue, other factors may cause our operating results, and therefore our stock price, to fluctuate.**

Our SubscribeNet service fees, which comprise most of our revenue, are recognized ratably over contract terms of generally one year, thereby limiting the quarter-to-quarter volatility of those revenues. Nevertheless, certain factors may cause our revenue to fluctuate. In addition to the other risk factors described in this section, factors that could cause such fluctuation include:

- An increasing percentage of our revenues are based upon variable fee provisions in our agreements. Those variable revenues fluctuate based on the degree to which customers are using our SubscribeNet service, which is difficult to predict in advance;
- Deferral of SubscribeNet revenue recognition due to: delays by customers in implementing the SubscribeNet service; new sales involving extensive implementations; or contract modifications adding significant future deliverables;
- Unexpected increases in customer cancellations, which could result from service deficiencies, or from external conditions or circumstances beyond our control;
- Lengthening of the sales cycle for our SubscribeNet service due to macroeconomic or other factors;
- Actual events, circumstances, outcomes, and amounts differing from judgments, assumptions, and estimates used in determining the values of certain assets (including the amounts of related valuation allowances), liabilities and other items reflected in our financial statements or unaudited interim financial statements; and

- Changes in accounting rules, such as recording expenses for employee stock option grants.

Consequently, operating results for a particular future period are difficult to predict, and prior results are not necessarily indicative of results to be expected in future periods. Any of these factors could materially adversely affect our results of operations and stock price.

**The technological and functional requirements we must meet to stay competitive are subject to rapid change. If we are unable to quickly adapt to these changes and meet the demands of our current and potential customers, we will likely lose sales and market share and our revenue growth will be limited.**

We market primarily to enterprise technology companies who generally demand that a service like ours meet high technological and functional standards. To remain competitive in this market and meet the demands of current and prospective customers, we must continually adapt and upgrade our technology and functionality, including through investments in additional functionality for our SubscribeNet service and underlying proprietary software. In addition, we are developing new functionality to reach new markets outside of the enterprise software industry, which are similarly competitive and demanding. We are a small company with limited resources available for enhancing and expanding our services. If we do not respond quickly enough to changing industry standards or the increased demands of customers and potential customers, we will likely lose sales and market share to competitors and our growth prospects will be limited. In addition, we could incur substantial costs to modify our services or infrastructure in order to adapt to changing standards and demands. If we incur such costs and our sales fail to increase commensurately, we may not be able to achieve sustained profitability and positive operating cash flow.

**Defects in our SubscribeNet service could diminish demand for the service and subject us to substantial liability.**

Our SubscribeNet service is complex and may have errors or defects that users identify after they begin using it, which could harm our reputation and our business. Internet-based services frequently contain undetected errors when first introduced or when new versions or enhancements are released. Despite taking precautions to avoid errors, we have found defects in our service from time to time, and we may find new errors in our existing service in the future. Because our customers use our service for important aspects of their business, any errors, defects or other performance problems with our service could hurt our reputation and may damage our customers' businesses. If that occurs, customers could elect not to renew their agreements with us, could be eligible for credits under our service level agreements, and could delay or withhold payment to us. We also could lose future sales, or customers may make warranty claims against us, which could result in an increase in our provision for doubtful accounts and revenue reserve, an increase in collection cycles for accounts receivable, or the expense and risk of litigation.

**Interruptions or delays in service from our third-party web hosting facilities, or in our relationships with third party hardware and software vendors, could impair the delivery of our SubscribeNet service and harm our business.**

We provide our service through computer hardware that is currently located in third-party web hosting facilities in Santa Clara, California operated by SAVVIS Communications, and in various locations that are used to support the Akamai, Inc. network. We do not control the operation of these facilities, and they are subject to damage or interruption from earthquakes, floods, fires, power loss, telecommunications failures and similar events. While physical security measures are in place, they are also subject to break-ins, sabotage, intentional acts of vandalism and similar misconduct. Despite precautions taken at the facilities, the occurrence of a natural disaster, a decision to close a facility without adequate notice, or other unanticipated problems at a facility, could result in lengthy interruptions in our service. In addition, the failure by either facility to provide our required data communications capacity could result in interruptions in our service. Any damage to, or failure of, our systems could result in interruptions in our service. Interruptions in our service may reduce our revenue, cause us to issue credits or pay penalties, cause customers to terminate their subscriptions and adversely affect our renewal rates. Our business will be harmed if our customers and potential customers believe our service is unreliable.

In addition, to a significant degree, we rely on various third-party software applications and hardware to deliver our service. If we experience disruptions in those vendor relationships and those software and hardware components become unavailable to us, or unavailable on commercially reasonable terms, our service could be interrupted and/or damaged, causing harm to our customer relationships, our reputation, and our overall business.

**We may raise additional capital to fund acquisitions, product development or general operations. Any such capital financing would dilute our shareholders' investments.**

We may raise additional capital in the future through private or public offerings of stock, or through other means. The purposes of any such financing would be to increase our cash reserves for potential use in acquiring other businesses, product development activities, funding our operations and generally strengthening our balance sheet. Any such additional financing would likely dilute the investments of our current shareholders and may not be available on favorable terms, if at all.

**A large percentage of our stock is owned by a small number of stockholders, which can lead to fluctuations and volatility in our stock price and insurmountable voting power.**

As of December 31, 2007, approximately 40% of our common stock, on an as-converted basis, was held by three investors. Those three investors are Digital River, Inc., Prescott Group Capital Management, L.L.C., and two affiliated funds, Special Situations Technology Fund, L.P. (Tech) and Special Situations Technology II, L.P. (Tech II). Because the ownership of our stock is so concentrated, there is a high risk that a large sale of shares by any of those stockholders could cause a rapid decline in our stock price, in which case our other stockholders and the company itself could be harmed. In addition, the collective voting power of those stockholders is, as a practical matter, nearly sufficient to control the outcome of any matter put to a majority vote of the stockholders.

**Our operating results could vary due to the methods, estimates and judgments we use in applying our accounting policies, particularly SFAS 123(R).**

The methods, estimates and judgments we use in applying our accounting policies significantly impact our results of operations. Those methods, estimates and judgments are, by their nature, subject to substantial risks, uncertainties and assumptions, and factors may arise over time that lead us to change our methods, estimates and judgments. In particular, the calculation of share-based compensation expense under SFAS 123(R), which we adopted as of the fiscal quarter beginning March 1, 2006, requires that we use valuation methodologies and a number of assumptions, estimates and conclusions regarding matters such as expected terms, expected forfeitures, expected volatility of our share price, the expected dividend rate with respect to our common stock and the exercise behavior of our employees. Furthermore, there are no means, under applicable accounting principles, to compare and adjust our expense if and when we learn of additional information that may affect our previous estimates, with the exception of changes in expected forfeitures of share-based awards. Over time, factors may arise that cause us to change our estimates and assumptions with respect to future share-based compensation arrangements, resulting in variability in our share-based compensation expense. In addition, any future accounting pronouncements, taxation rules, and new interpretations of existing accounting pronouncements or taxation rules, could also have a significant effect on our reported results, including our reporting of transactions completed before the effective date of the change.

**Provisions of our charter documents could make it more difficult for a third party to acquire us, even if the offer may be considered beneficial by our stockholders, which could depress the trading price of our common stock.**

Our charter documents, as well as our Second Amended and Restated Preferred Stock Rights Agreement, contain provisions that could depress the trading price of our common stock by acting to discourage, delay or prevent a change in control of our company or changes in our management that the stockholders of our company may deem advantageous. These provisions include:

- Certain stockholder rights that are triggered in the event a person or entity acquires more than 15% of our voting securities (or up to 20% in the cases of Crosslink Capital, Inc. and Special Situations Technology Funds.);



- The establishment of a classified board of directors so that not all members of our board are elected at one time;
- The requirement of a super-majority voting to amend some provisions in our amended and restated certificate of incorporation and bylaws;
- The authorization to issue "blank check" preferred stock by our board to increase the number of outstanding shares and to discourage a takeover attempt;
- The prohibition of stockholder action by written consent, which requires all stockholder actions to be taken at a meeting of our stockholders;
- The board of directors is expressly authorized to make, alter or repeal our bylaws; and
- Advance notice requirements for nominations for election to our board or for proposing matters that can be acted upon by stockholders at stockholder meetings.

In addition, Section 203 of the Delaware General Corporation Law may discourage, delay or prevent a change in control of our company. Section 203 imposes certain restrictions on merger, business combinations and other transactions between us and holders of 15% or more of our common stock.

**Viruses may hinder acceptance of internet-based digital delivery, which could in turn limit our revenue growth.**

The proliferation of software viruses is a key risk that could inhibit acceptance by information technology professionals of web-based delivery of digital goods. Any well-publicized transmission of a computer virus by us or another company using digital delivery could deter information technology professionals from using, and deter software providers from outsourcing, digital delivery, thereby adversely affecting our business. Our SubscribeNet service enables our customers to upload their software products directly onto our systems for downloading by their end-users. Our systems automatically scan our customers' software products for known computer viruses on an ongoing basis while they are on our systems. However, it is possible that even with these periodic virus scans, our system could transmit the virus to one or more end-users. Any such virus transmission could result in disputes, litigation and negative publicity that could adversely affect our business and our stock price.

**If our security measures are breached and unauthorized access is obtained to a customer's data, our SubscribeNet service may be perceived as not being secure and customers may curtail or stop using our service.**

Our SubscribeNet service involves the storage and transmission of customers' proprietary information, and security breaches could expose us to a risk of loss of this information, litigation and possible liability. If our security measures are breached as a result of third-party action, employee error, malfeasance or otherwise, and, as a result, someone obtains unauthorized access to one of our customer's data, our reputation will be damaged, our business may suffer and we could incur significant liability. Because techniques used to obtain unauthorized access or to sabotage systems change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. If an actual or perceived breach of our security occurs, the market perception of the effectiveness of our security measures could be harmed and we could lose sales and customers. Some companies may be reluctant to use either our SubscribeNet or Digital Fastball services because they are concerned about the security capabilities of these services.

**Additional government regulations may harm demand for our services and increase our costs of doing business.**

Our business has benefited from the tax laws of states in which purchases of software licenses are not taxable if the software is received only electronically. Some such states are considering whether to change their laws

to broaden the taxability of transactions fulfilled over the internet. Any new imposition of taxes on sales of software licenses where the software is received electronically could substantially harm demand for our services and thereby materially adversely affect our business, operating results and financial condition. We also have benefited from implementing our services in Ireland, which offers tax advantages to software companies distributing software from Ireland. Any regulatory change in Ireland or elsewhere that diminishes those advantages could harm our business. Other changes in government regulations, in areas such as privacy and export compliance, could also require us to implement changes in our services or operations that increase our cost of doing business and thereby hurt our financial performance.

**Claims by third parties for intellectual property infringement could force us to stop selling our services, force us to pay royalties, and force us to indemnify our customers.**

Our business involves a high risk that we will be the target of intellectual property infringement claims. These claims could take a number of forms, including:

- Claims by other technology companies alleging that current or future components of our digital delivery service or related services infringe their intellectual property rights;
- Claims by our customers' competitors alleging that our customers' software, which we store and electronically deliver for our customers, infringes those competitors' intellectual property rights (our customers would typically be required to defend and indemnify us against such claims, but the claims could nevertheless disrupt our business);
- Claims that our use of the name "Intraware" violates the rights of other entities that are using the same name. We are aware that certain other companies are using the name "Intraware" as a company name or as a trademark or service mark. While we have received no notice of any claims of trademark infringement from any of those companies, we cannot assure you that these companies may not claim superior rights to "Intraware" or to other marks we use; or
- Claims by our customers that we delivered their software to unauthorized third parties, thereby infringing our customers' intellectual property rights.

Industry consolidation is increasing the risk that we will become a target of the types of infringement claims described in the first two bullets above. Consolidation among companies providing digital delivery, licensing, e-commerce and related technologies is resulting in more direct competition among the surviving companies in that segment, heightening the risk of intellectual property infringement claims among those companies, including us. Similarly, consolidation in the enterprise software industry heightens the risk of intellectual property infringement claims among the companies remaining in that industry, including most of our customers.

These intellectual property claims could be made for patent, copyright or trademark infringement or for misappropriation of trade secrets. They could be made directly against us, or indirectly through our contractual indemnification obligations to our customers and channel partners. Any claims could result in costly litigation and be time-consuming to defend, divert management's attention and resources, or cause delays in releasing new or upgrading existing services. Royalty or licensing agreements, if required, may be available only on onerous terms, if at all. Although we carry general liability insurance, our insurance may not cover all potential claims or may not be adequate to protect us from all liability that may be imposed.

We believe we own the rights in, or have the rights required to use, our SubscribeNet technology. However, there can be no assurance that this technology does not infringe the rights of third parties. In addition, we take steps to verify that end-users who download our customers' software through our SubscribeNet service are entitled to deploy and use that software. However, there can be no assurance that this verification procedure will help us defend against claims by, or protect us against liability to, our customers whose software is downloaded.

**If our export compliance system fails to prevent unauthorized exports of our customers' software, we could be sanctioned by the U.S. government.**

Through our SubscribeNet service, we globally distribute software containing encryption technology and other technologies restricted by U.S. laws and regulations from exportation to certain countries, certain types of recipients, and certain specific end-users. Our SubscribeNet service incorporates automated procedures to help ensure that the software we deliver electronically is not downloaded in violation of U.S. export laws and regulations. However, these procedures may not prevent unauthorized exports of restricted software in every case. If an unauthorized export of software occurs through our SubscribeNet service and the U.S. government determines that we have violated U.S. export laws or regulations, we could be sanctioned under those laws or regulations. Sanctions include fines, suspension or revocation of export privileges, and imprisonment.

**If our key personnel left our company, our product development, sales, and corporate management could suffer.**

Our future success depends upon the continued service of our executive officers and other key technology, sales, marketing and support personnel. None of our officers or key employees is bound by an employment agreement for any specific term. We do not maintain life insurance on any of our officers or key employees. If we lose the services of one or more of our key employees, or if one or more of our executive officers or key employees decides to join a competitor or otherwise compete directly or indirectly with us, this could significantly harm our business.

**Financial and securities laws, especially the Sarbanes-Oxley Act of 2002, require that we evaluate our internal control structure. While we believe we currently have adequate internal controls in place, this exercise has no precedent available by which to measure the adequacy of our compliance, and in addition it may cause our operating expenses to increase.**

The Sarbanes-Oxley Act of 2002 and newly proposed or enacted rules and regulations of the SEC and the NASDAQ Stock Market impose new duties on us and our executives, directors, attorneys and independent registered public accounting firms. In order to comply with the Sarbanes-Oxley Act and such new rules and regulations, we are evaluating our internal controls over financial reporting to allow management to report on, and our independent registered public accounting firm will, in the future, need to attest to, our internal controls over financial reporting. We are performing the system and process evaluation and testing (and any necessary remediation) required in an effort to comply with the management certification and independent registered public accounting firm attestation requirements of Section 404 of the Sarbanes-Oxley Act. As a result, we are incurring additional expenses and diversion of management's time, and we may be required to hire additional personnel and engage additional outside legal, accounting and advisory services. Any of these developments could materially increase our operating expenses and accordingly reduce our net income or increase our net loss. While we anticipate being able to fully implement the requirements relating to internal control over financial reporting and all other aspects of Section 404 in a timely fashion, we cannot be certain as to the outcome of our testing and resulting remediation actions or the impact of the same on our operations since there is little precedent available by which to measure compliance adequacy. If we are unable to implement the requirements of Section 404 in a timely manner or with adequate compliance, we may be subject to sanctions or investigation by regulatory authorities, such as the SEC or the NASDAQ Stock Market, and our reputation may be harmed. Any such action could adversely affect our financial results and the price of our common stock.

Moreover, our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls or our internal controls over our financial reporting will eliminate all risk of error or fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Our disclosure controls or procedures could be circumvented by the individual acts of some persons, by collusion of two or more people or by management override of the control. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Under the current rules, we expect that we will be required by the Sarbanes-Oxley Act to include a management assessment of our internal controls over financial reporting beginning with our Annual Report on Form 10-K for our fiscal year ending February 29, 2008, and our independent registered accounting firm to attest to our internal controls over financial reporting beginning with our Annual Report on Form 10-K for our fiscal year ending February 28, 2009.

**If we acquire any companies or technologies in the future, or enter into joint ventures, they could prove difficult to integrate, disrupt our business, dilute stockholder value and adversely affect our operating results.**

We may acquire or make investments in complementary companies, services and technologies in the future. Similarly, we may enter into joint ventures as we try to penetrate new markets. We are considerably smaller now than we were when we made our past acquisitions, and therefore any new acquisitions or investments could be more disruptive to our organization than in the past. Acquisitions and investments involve numerous risks, including:

- difficulties in integrating operations, technologies, services and personnel;
- diversion of financial and managerial resources from existing operations;
- risk of entering new markets;
- potential write-offs of acquired assets;
- potential loss of key employees;
- inability to generate sufficient revenue to offset acquisition or investment costs; and
- delays in customer purchases due to uncertainty.

In addition, if we finance acquisitions by issuing convertible debt or equity securities, our existing stockholders may be diluted which could affect the market price of our stock. As a result, if we fail to properly evaluate and execute acquisitions or investments, our business and prospects may be seriously harmed.

**We could face claims in relation to our Employee Stock Purchase Plan.**

We have maintained an ESPP program for the benefit of our employees since 1999. In 2006, we determined that beginning in late 2001, we issued shares that were authorized under our ESPP plan but which exceeded the number of shares we had registered with the SEC on Form S-8. In October 2006, we registered additional ESPP shares with the SEC, but it is possible we could face claims for rescission of past purchases or other damages by former employees who lost money selling their ESPP shares. It is difficult to predict the overall size of these potential claims because we do not have data showing the extent to which employees or former employees continue to hold their shares or have sold them, or data showing any resulting losses. While we believe the aggregate amount of potential claims is small, we cannot assure you of this. We also believe we have valid defenses against any such claims, including without limitation applicable statutes of limitation, but the cost of litigating these issues could be expensive and we cannot assure you we would prevail on all of our defenses or avoid rescinding certain purchases under the ESPP and/or paying damages.

## ITEM 6. EXHIBITS

<b>Exhibit Number</b>	<b>Description</b>
3.1(1)	Amended and Restated Certificate of Incorporation of Intraware, Inc.
3.2(1)	Certificate of Amendment to Amended and Restated Certificate of Incorporation of Intraware, Inc.
3.3(2)	Certificate of Amendment to Amended and Restated Certificate of Incorporation of Intraware, Inc.
3.4(3)	Certificate of Designations, Preferences and Rights of Series A Convertible Preferred Stock
3.5(4)	Certificate of Designations, Preferences and Rights of Series B Convertible Preferred Stock
3.6(1)	Certificate of Designations, Preferences and Rights of Series D Convertible Preferred Stock
3.7*	Amended and Restated Bylaws of Intraware, Inc.
4.1(5)	Second Amended and Restated Preferred Stock Rights Agreement, dated as of January 22, 2007 between Intraware, Inc. and Computershare Investor Services LLC, including the Certificate of Designation, the form of Rights Certificate and the Summary of Rights attached thereto as Exhibits A, B and C, respectively
31.1*	Certification pursuant to Section 302 of the Sarbanes-Oxley Act - Peter H. Jackson
31.2*	Certification pursuant to Section 302 of the Sarbanes-Oxley Act - Wendy A. Nieto
32.1*	Certification pursuant to Section 906 of the Sarbanes-Oxley Act

(1) Incorporated by reference to our Quarterly Report on Form 10-Q for the quarter ended August 31, 2005, filed with the SEC on October 5, 2005.

(2) Incorporated by reference to our Quarterly Report on Form 10-Q for the quarter ended November 30, 2006, filed with the SEC on January 16, 2007.

(3) Incorporated by reference to our Current Report on Form 8-K dated April 2, 2001, filed with the SEC on April 13, 2001.

(4) Incorporated by reference to our Current Report on Form 8-K dated November 9, 2005, filed with the SEC on November 15, 2005.

(5) Incorporated by reference to our Current Report on Form 8-K dated January 19, 2007, filed with the SEC on January 23, 2007.

\* Filed Herewith

SIGNATURE

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

**INTRAWARE, INC.**

Date: January 11, 2008

By: /s/ WENDY A. NIETO

Wendy A. Nieto  
Chief Financial Officer and Executive Vice  
President