SCIENTIFIC LEARNING CORP
Form 10-Q
November 07, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)**
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2007

OR

o **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 000-24547

Scientific Learning Corporation

(Exact name of registrant as specified in its charter)

Delaware	**94-3234458**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

300 Frank H. Ogawa Plaza, Suite 600
Oakland, California 94612
(510) 444-3500
(Address of Registrant's principal executive offices, including zip code, and telephone number, including area code)

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

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

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

As of October 15, 2007, there were 17,271,877 shares of Common Stock outstanding.

SCIENTIFIC LEARNING CORPORATION

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FOR THE QUARTER ENDED September 30, 2007

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Scientific Learning Corporation
Condensed Balance Sheets
(In thousands)
Unaudited

	September 30, 2007	December 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 19,877	$ 16,364
Accounts receivable, net	9,779	7,098
Prepaid expenses and other current assets	1,439	971
Total current assets	31,095	24,433
Property and equipment, net	1,705	941
Other assets	915	909
Total assets	$ 33,715	$ 26,283
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 394	$ 607
Accrued liabilities	4,633	5,089
Deferred revenue	17,504	14,786
Total current liabilities	22,531	20,482
Deferred revenue, long-term	6,771	4,373
Other liabilities	443	411
Total liabilities	29,745	25,266
Stockholders' equity:		
Common stock and additional paid in capital	81,585	78,909
Accumulated deficit	(77,615)	(77,892)
Total stockholders' equity:	3,970	1,017
Total liabilities and stockholders' equity	$ 33,715	$ 26,283

See accompanying notes.

Scientific Learning Corporation
Condensed Statements of Operations
(In thousands, except per share amounts)
Unaudited

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
Revenues:				
Products	$ 7,456	$ 7,006	$ 23,935	$ 22,882
Service and support	3,894	2,919	10,805	7,827
Total revenues	11,350	9,925	34,740	30,709
Cost of revenues:				
Cost of products	459	433	1,259	1,282
Cost of service and support	1,872	2,089	6,213	5,916
Total cost of revenues	2,331	2,522	7,472	7,198
Gross profit	9,019	7,403	27,268	23,511
Operating expenses:				
Sales and marketing	6,143	5,084	18,745	15,906
Research and development	1,016	1,057	3,385	3,170
General and administrative	1,890	1,837	5,721	5,035
Total operating expenses	9,049	7,978	27,851	24,111
Operating loss	(30)	(575)	(583)	(600)
Other income from related party	68	38	185	112
Interest and other income	230	192	701	370
Net income (loss) before income tax	268	(345)	303	(118)
Income tax provision (benefit)	22	(13)	26	—
Net income (loss)	$ 246	$ (332)	$ 277	$ (118)
Basic net income (loss) per share:	$ 0.01	$ (0.02)	$ 0.02	$ (0.01)
Shares used in computing basic net income (loss) per share	17,240	16,861	17,119	16,823
Diluted net income (loss) per share:	$ 0.01	$ (0.02)	$ 0.02	$ (0.01)
Shares used in computing diluted net income (loss) per share	18,369	16,861	18,272	16,823

See accompanying notes.

Scientific Learning Corporation
Condensed Statements of Cash Flows
(In thousands)
Unaudited

	Nine Months Ended September 30,	
	2007	**2006**
Operating Activities:		
Net income	$ 277	$ (118)
Adjustments to reconcile net income to cash used in operating activities:		
Depreciation and amortization	227	380
Stock based compensation	1,637	1,680
Changes in operating assets and liabilities:		
Accounts receivable	(2,681)	(7,331)
Prepaid expenses and other current assets	(468)	(92)
Other assets	(6)	24
Accounts payable	(213)	9
Accrued liabilities	(456)	2,737
Deferred revenue	5,116	4,001
Other liabilities	32	15
Net cash provided by operating activities	3,465	1,305
Investing Activities:		
Purchases of property and equipment, net	(991)	(581)
Maturity of investments	—	3,043
Repayment on officer loans and accrued interest	—	213
Net cash provided by (used in) investing activities	(991)	2,675
Financing Activities:		
Proceeds from issuance of common stock, net	1,039	335
Net cash provided by financing activities	1,039	335
Increase in cash and cash equivalents	3,513	4,315
Cash and cash equivalents at beginning of period	16,364	9,022
Cash and cash equivalents at end of period	$ 19,877	$ 13,337

See accompanying notes.

Supplemental schedule of noncash financing activities:		
Common stock surrendered in connection with repayment of officer loans	—	$ 84

Notes to Condensed Financial Statements

1. Summary of Significant Accounting Policies

Description of Business

Scientific Learning Corporation creates educational software that accelerates learning by improving the processing efficiency of the brain. The patented *Fast ForWord* family of products, based on more than 30 years of neuroscience and cognitive research, provides struggling readers with computer-delivered interventions and intensive exercises that build the cognitive skills required to read and learn effectively. To facilitate the use of our products, we offer a variety of on-site and remote professional and technical services, as well as phone, email and web-based support. We sell primarily to K-12 schools in the United States through a direct sales force.

All of our activities are in one operating segment.

We were incorporated in 1995 in the State of California and were reincorporated in 1997 in the State of Delaware.

Use of Estimates

The preparation of financial statements, in conformity with accounting principles generally accepted in the United States, requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the financial statements as well as the reported amounts of revenues and expenses during the periods presented. To the extent that there are material differences between these estimates and actual results, our financial statements could be affected.

Interim Financial Information

The interim financial information as of September 30, 2007 and for the three and nine months ended September 30, 2007 and 2006 is unaudited, but includes all normal recurring adjustments that we consider necessary for the fair presentation of our financial position at such date and our results of operations and cash flows for those periods.

These condensed financial statements and notes should be read in conjunction with our audited financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in our Annual Report on Form 10-K for the year ended December 31, 2006, filed with the Securities and Exchange Commission.

Revenue Recognition

We derive revenue from the sale of licenses to our software and from service and support fees. Software license revenue is recognized in accordance with AICPA Statement of Position 97-2, "*Software Revenue Recognition*," as amended by Statement of Position 98-9 (SOP 97-2). SOP 97-2 provides specific industry guidance and four basic criteria, which must be met to recognize revenue. These are: 1) persuasive evidence of an arrangement exists; 2) delivery of the product has occurred; 3) a fixed or determinable fee; and 4) the probability that the fee will be collected. The application of SOP 97-2 requires us to exercise significant judgment related to our specific transactions and transaction types.

Sales to our school customers typically include multiple elements (e.g., Fast ForWord software licenses, Progress Tracker, our Internet-based participant tracking service, support, training, implementation management, and other services). We allocate revenue to each element of a transaction based upon its fair value as determined in reliance on "vendor specific objective evidence" ("VSOE"), if VSOE exists for each element. As we do not have VSOE for software licenses, we normally recognize revenue using the residual method on arrangements with multiple elements that include software licenses, whereby the difference between the total arrangement fee and the total fair value of the undelivered elements (generally services and support) is recognized as revenue relating to software licenses. VSOE of fair value for each element of an arrangement is based upon the normal pricing and discounting practices for those products and services when sold separately and, for support services, is also measured by the renewal price. We are required to exercise judgment in determining whether VSOE exists for each undelivered element based on whether our pricing for these elements is sufficiently consistent.

Notes to Condensed Financial Statements

1. Summary of Significant Accounting Policies (continued)

The value of software licenses, services and support invoiced during a particular period is recorded as deferred revenue until recognized. All revenue from transactions that include new products that have not yet been delivered is deferred until the delivery of all products. Deferred revenue is recognized as revenue as discussed below.

Product revenue

Product revenue is primarily derived from the licensing of software and is recognized as follows:

- Perpetual licenses – software licensed on a perpetual basis. Revenue is recognized at the later of product delivery date or contract start date using the residual method. If VSOE does not exist for all the undelivered elements, all revenue is deferred and recognized ratably over the service period if the undelivered element is services or when all elements have been delivered.

- Term licenses – software licensed for a specific time period, generally three to twelve months. Revenue is recognized ratably over the license term.

- Individual participant licenses – software licensed for a single participant. Revenue is recognized over the average period of use, typically six weeks.

Service and support revenue

Service and support revenue is derived from a combination of training, implementation, technical and professional services, online services and customer support. Training, technical and other professional services are typically sold on a per day basis. If VSOE exists for all elements of an arrangement or all elements except software licenses, services revenue is recognized as performed. If VSOE does not exist for all the elements in an arrangement except software licenses, service revenue is recognized over the longest contractual period in an arrangement. Revenue from services sold alone or with support is recognized as performed.

Cash and Cash Equivalents

We consider all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. Cash and cash equivalents, which primarily consist of cash on deposit with banks, money market funds, and US Government agencies with a maturity of three months or less, are stated at cost, which approximates fair value.

Other Assets

Other assets consist of the following (in thousands):

	September 30, 2007	December 31, 2006
Long-term lease deposits	$ 855	$ 855
Other non current assets	60	54
	$ 915	$ 909

Net Income (Loss) Per Share

Basic net income (loss) per share is computed using the weighted-average number of common shares outstanding during the period. Diluted net income per share reflects the potential dilution of securities by adding common stock equivalents (computed using the treasury stock method) to the weighted-average number of common shares outstanding during the period, if dilutive.

Notes to Condensed Financial Statements

1. Summary of Significant Accounting Policies (continued)

The following table sets forth the computation of net income per share (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Net income (loss)	$ 246	$ (332)	$ 277	$ (118)
Weighted average shares used in calculation of basic net income (loss) per share	17,240	16,861	17,119	16,823
Effect of dilutive securities:				
Employee stock options and awards	1,129	—	1,153	—
Weighted-average diluted common shares	18,369	16,861	18,272	16,823
Net income (loss) per common share - basic	$ 0.01	$ (0.02)	$ 0.02	$ (0.01)
Net income (loss) per common share - diluted	$ 0.01	$ (0.02)	$ 0.02	$ (0.01)

Fair Value Measurement

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, “Fair Value Measurements” (“SFAS 157”). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We do not believe that the adoption of SFAS 157 will have a material impact on our financial condition and results of operations.

In February 2007, the FASB issued Statement No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (“SFAS 159”), including an amendment of FASB Statement No. 115, which allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on an instrument-by-instrument basis. Subsequent measurements for the financial assets and liabilities an entity elects to record at fair value will be recognized in earnings. Statement 159 also establishes additional disclosure requirements. Statement 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of the adoption of SFAS 159 on our financial condition and results of operations.

2. Stock-Based Compensation

Compensation Cost

The following table summarizes our stock-based compensation expense resulting from the application of SFAS 123R in the three and nine months ended September 30, 2007 and 2006 (in thousands):

Three Months Ended September 30,		Nine Months Ended September 30,	
2007	2006	2007	2006

	Three Months Ended September 30,		Nine Months Ended September 30,	
Cost of service and support revenues	$ 55	$ 51	$ 158	$ 148
Sales and marketing	245	185	635	539
Research and development	99	83	284	234
General and administrative	302	470	560	759
Total stock-based compensation expense	$ 701	$ 789	$ 1,637	$ 1,680

Notes to Condensed Financial Statements

2. Stock-Based Compensation (continued)

Valuation of Stock Option Awards

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model. This model requires the input of subjective assumptions, including expected stock price volatility, the estimated life of each award and estimated pre-vesting forfeitures. The fair value of these stock options was estimated assuming no expected dividends and estimates of expected life, volatility and risk-free interest rate at the time of grant. Estimated volatility is based on the historical prices of our common stock over the expected life of each option. Expected life of the options is based on our history of option exercise and cancellation activity. The risk free interest rates used are based on the U.S. Treasury yield curve in effect at the time of grants for periods corresponding with the expected life of the options. We use historical data to estimate pre-vesting option forfeitures. We recognize compensation expense for the fair values of these awards, which typically have graded vesting, on a straight-line basis over the requisite service period of each of these awards.

In July 2007 we made a grant of 100,000 stock options containing a market condition to a new Board member in respect of a consulting agreement. The vesting of these options will occur if certain predefined stock price thresholds are met. These options have been valued at an average of $2.78 per share using a Monte Carlo Simulation process to reflect the effect of the market condition in the grant date fair value of the award.

The fair value of stock options granted was estimated using the following weighted-average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Expected life (in years)	4	4	4	4
Risk-free interest rate	4.9%	5.1%	4.9%	5.1%
Dividend yield	0.0%	0.0%	0.0%	0.0%
Expected volatility	49%	80%	49%	80%

Summary of Stock Options

The following table summarizes all stock option activity under our share-based compensation plans for the nine months ended September 30, 2007:

	Outstanding Options			
	Number of Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2006	3,299,539	$ 4.23		
Granted	225,000	$ 7.19		
Exercised	(180,302)	$ 4.53		
Forfeited and expired	(35,987)	$ 9.67		
Outstanding at September 30, 2007	3,308,250	$ 4.36	4.98	$ 7,643,032
Vested and expected to vest at September 30, 2007	2,746,814	$ 4.60	4.97	$ 5,894,315
Exercisable at September 30, 2007	2,170,946	$ 5.00	4.87	$ 4,156,037

Notes to Condensed Financial Statements

2. Stock-Based Compensation (continued)

The aggregate intrinsic value of options outstanding at September 30, 2007 is calculated as the difference between the exercise price of the underlying options and the market price of our common stock for the 2,717,692 shares that had exercise prices that were lower than the $6.00 market price of our common stock at September 30, 2007 (“in the money options”). The total intrinsic value of options exercised during the nine months ended September 30, 2007 and 2006 was $409,000 and $128,000, respectively. The intrinsic value of options vested during the nine months ended September 30, 2007 and 2006 was $1.5 million and $1.6 million, respectively.

The following table summarizes information concerning outstanding and exercisable stock options at September 30, 2007:

	Outstanding			Exercisable	
Price Range	Number of Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Life (Years)	Number of Shares	Weighted Average Exercise Price Per Share
$0.60 - $1.39	1,098,637	$ 1.38	4.7	348,637	$ 1.35
$1.40 - $3.59	450,033	$ 1.97	4.8	450,033	$ 1.97
$3.90 - $5.64	628,630	$ 4.85	5.2	591,861	$ 4.81
$5.65 - $6.00	540,392	$ 5.96	7.1	375,452	$ 5.96
$6.01 - $30.50	590,558	$ 9.74	3.3	404,963	$ 10.90
	3,308,250	$ 4.36	5.0	2,170,946	$ 5.00

As of September 30, 2007, total unrecognized compensation cost related to stock options granted under our various plans was $1.2 million. We expect that cost to be recognized over a weighted-average period of 1.1 years.

Summary of Restricted Stock Units

The following table summarizes all restricted stock unit activity under our share-based compensation plan for the nine months ending September 30, 2007:

	Outstanding Restricted Stock Units		
	Number of Shares	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2006	229,000		
Awarded	306,500		
Vested	(78,500)		
Forfeited or expired	(8,500)		
Outstanding at September 30, 2007	448,500		
Vested and expected to vest at September 30, 2007	337,147	1.58	$ 2,022,883

Notes to Condensed Financial Statements

2. Stock-Based Compensation (continued)

Restricted stock units were awarded for the first time in 2006 under our 1999 Equity Incentive Plan. The fair value of these grants was calculated based upon the fair market value of our stock at the date of grant, less an estimate of pre-vesting forfeitures. The weighted-average grant-date fair value of restricted stock units awarded during the nine months ending September 30, 2007 and 2006 was $7.05 and $4.84, respectively.

Employee Stock Purchase Plan ("ESPP")

ESPP awards were valued using the Black-Scholes model using the following assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Expected life (in years)	0.5 - 1	0.5 - 1	0.5 - 1	0.5 - 1
Risk-free interest rate	5.0%	4.8%	5.0%	4.0%
Dividend yield	0.0%	0.0%	0.0%	0.0%
Expected volatility	41%	32%	48%	41%

Disclosures Pertaining to All Share-Based Compensation Plans

Cash received under all share-based payment arrangements for the nine months ended September 30, 2007 and 2006 was $1 million and $335,000, respectively, which related to the exercise of stock options and the purchase of ESPP shares. Because of our net operating losses and related valuation allowance, we did not realize any tax benefits for the tax deductions from share-based payment arrangements during the nine months ended September 30, 2007 or 2006.

3. Comprehensive Income (Loss)

We have no items of other comprehensive income (loss), and accordingly, the comprehensive income (loss) is equal to net income (loss) for all periods presented.

4. Warranties; Indemnification

We generally provide a warranty that our software products substantially operate as described in the manuals and guides that accompany the software for a period of 90 days. The warranty does not apply in the event of misuse, accident, and certain other circumstances. To date, we have not incurred any material costs associated with these warranties and have no accrual for such items at September 30, 2007.

From time to time, we enter into contracts that require us, upon the occurrence of certain contingencies, to indemnify parties against third party claims. These contingent obligations primarily relate to (i) claims against our customers for violation of third party intellectual property rights caused by our products; (ii) claims resulting from personal injury or property damage resulting from our activities or products; (iii) claims by our office lessor arising out of our use of the premises; and (iv) agreements with our officers and directors under which we may be required to indemnify such persons for liabilities arising out of their activities on behalf of ourselves. Because the obligated amounts for these types of agreements usually are not explicitly stated, the overall maximum amount of these obligations cannot be reasonably estimated. No liabilities have been recorded for these obligations on our balance sheet as of September 30, 2007 or September 30, 2006.

Notes to Condensed Financial Statements

5. Related Party Transaction

In September 2003 we entered into an agreement with Posit Science Corporation (“PSC”), formerly Neuroscience Solutions Corporation, to provide PSC with exclusive rights in the healthcare field to certain intellectual property owned or licensed by us, along with transfer of certain healthcare research projects. A co-founder, substantial shareholder, and member of our Board of Directors, is a co-founder, officer, director and substantial shareholder of PSC.

During the three and nine months ended September 30, 2007, we recorded $68,000 and $185,000 in royalty income from PSC, respectively. For the comparable period in 2006, we recorded $38,000 and $112,000 in royalty income, respectively. Amounts received to date and any future receipts are being reported as other income as we do not consider these royalties to be part of our recurring operations.

6. Bank Line of Credit

On June 5, 2007 we amended and extended our existing revolving line of credit agreement with Comerica Bank. The maximum that can be borrowed under the agreement is $5.0 million. The line expires on December 2, 2008. Borrowing under the line of credit bears interest at a floating prime rate, or a fixed rate of LIBOR plus 2.5%. To secure the line we granted Comerica a security interest in all of our assets other than our intellectual property. We also agreed with Comerica that we will not grant a security interest in our intellectual property to any third party. Borrowings under the line are subject to various covenants. The agreement includes a letter of credit sublimit not to exceed $1.0 million. At September 30, 2007, we have an outstanding letter of credit for $200,000. There were no borrowings outstanding on the line of credit at September 30, 2007.

7. Provision for Income Taxes

In the nine months ended September 30, 2007, we recorded an income tax provision of $26,000 based on our expectation that we will be profitable for the fiscal year. For the nine months ended September 30, 2006, we did not record any tax provision. The tax provision principally consists of federal and state taxes currently payable offset by the utilization of net operating losses resulting in an effective tax rate, excluding discrete items, of approximately 7.12%. In the three months ended September 30, 2007, we recorded an income tax provision of $22,000, resulting in a period tax rate of approximately 8.30%. Statement of Financial Accounting Standards No. 109, “Accounting forIncome Taxes” (“SFAS 109”) provides for the recognition of deferred tax assets if realization of such assets in more likely than not. Based upon the weight of available evidence, which includes historical operating performance and previously reported net losses, we continue to maintain a full valuation allowance against our remaining net deferred tax assets. As a result of the change of control triggered by our secondary offering in July 2007, the utilization of our net operating losses will be limited in future periods.

Effective January 1, 2007, we adopted Financial Accounting Standards Interpretation, or FIN, No. 48, “Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109.” FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of uncertain tax positions taken, or expected to be taken, in a company’s income tax return; and also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The evaluation of a tax position under FIN No. 48 is a two-step process. Step one, recognition,, requires a company to determine if the weight of available evidence indicates that a tax position is more likely than not to be sustained upon audit, including resolution of related appeals or litigation processes, if any. Step two, measurement, is based on the largest amount of benefit, which is more likely than not to be realized on ultimate settlement. The cumulative effect of adopting FIN No. 48 on January 1, 2007 is recognized as a change in accounting principle, recorded as an adjustment to the opening balance of retained earnings on the adoption date.

Notes to Condensed Financial Statements

7. Provision for Income Taxes (continued)

As a result of the implementation of FIN No. 48, we did not recognize any increase or decrease in the liability for unrecognized tax benefits related to tax positions taken in prior periods, therefore, there was no corresponding adjustment in retained earnings. Additionally, FIN 48 specifies that tax provisions for which the timing of the ultimate resolution is uncertain should be recognized as long-term liabilities. For the three month period ending September 30, 2007, we reclassified $24,000 between current and long term taxes payable and made no such reclassifications upon adoption of FIN 48. Our total unrecognized tax benefits as of the January 1, 2007 adoption date and September 30, 2007 were $1.4 million and $1.8 million respectively. We have approximately $24,000 of unrecognized tax benefits that, if recognized, would affect our current effective income tax rate.

Our continuing practice is to recognize interest and penalties relating to income tax matters in income tax expense. We recorded approximately $5,000 of such expense in the three month period ended September 30, 2007, and had no accruals prior to the September 30, 2007 period.

Our only major tax jurisdiction is the United States and our 2003-2006 tax years remain subject to examination by the appropriate governmental agencies due to our operating loss positions. Our federal income tax return for 2004 is currently under examination.

8. Commitments and Contingencies

In September 2007, we received a demand letter from one of our field sales representatives seeking approximately $423,000 in additional commissions relating to a sale in the quarter ended June 30, 2007. Under the applicable incentive compensation plan, our management may reduce the commission for certain large sales if certain conditions are met. We believe those conditions were met and, therefore, reduced the respective commission. The claimant contends that we did not have the right to reduce the commission in these circumstances.

We believe that these claims are not meritorious and that we do not have any significant liability to this sales representative for additional commissions. We therefore do not believe that the resolution of this matter will have a material adverse effect on our financial position or results of operations.

Item 2. Management's Discussion and Analysis of Financial Conditions and Results of Operations

This report contains forward-looking statements. Forward-looking statements are not historical facts but rather are based on current expectations about our business and industry, as well as our beliefs and assumptions. Words such as "may," "will," "should," "expects," "intends," "plans," "anticipates," "believes," "estimates," "predicts," "potential," "continue" and variations and negatives of these words and similar expressions are used to identify forward-looking statements. Statements regarding our expectations for our future business results and financial position, our business strategies and objectives, and trends in our market are forward-looking statements. Forward-looking statements, are not guarantees of future performance or events, and are subject to risks, uncertainties and other factors, many of which are beyond our control and some of which we may not even be presently aware. As a result, our future results and other future events or trends may differ materially from those anticipated in our forward-looking statements. Specific factors that might cause such a difference include, but are not limited to, the risks and uncertainties discussed in this Management's Discussion and in the Risk Factors section of this Report. We also refer you to the risk factors that are or may be discussed from time to time in our public announcements and filings with the SEC, including our future Forms 8-K, 10-Q and 10-K. Readers are cautioned not to place undue reliance on forward-looking statements, which reflect our view only as of the date of this report. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise after the date of this report.

Overview

We create education software that accelerates learning by improving the processing efficiency of the brain. The patented *Fast ForWord* family of products provides struggling readers with computer-delivered interventions and intensive exercises that build the cognitive skills required to read and learn effectively. Based on more than 30 years of neuroscience and cognitive research, the *Fast ForWord* products apply patented technology and validated neuroscience principles of brain plasticity to help children, adolescents, and adults improve processing efficiency and achieve enduring gains. These results have been demonstrated through brain imaging studies, changes in achievement on standardized reading tests and more than 135 efficacy studies. Our products are marketed primarily to K-12 schools in the US, to whom we sell through a direct sales force. To facilitate the use of our products, we offer a variety of on-site and remote professional and technical services, as well as phone, email and web-based support. Since our inception, learners have used our *Fast ForWord* products over one million times and over 5,000 K-12 schools have purchased at least $10,000 of our *Fast ForWord* product licenses and services. As of September 30, 2007 we had 215 full-time equivalent employees, compared to 197 at December 31, 2006.

Business Highlights

We market our *Fast ForWord* products primarily as a reading intervention solution for struggling, at-risk, English language learning and special education students. Approximately 70% of the 55 million public and private school K-12 students in the United States test as not proficient in reading. While our installed base is growing, the over 5,000 schools that have purchased at least $10,000 of our product licenses and services represent a small fraction of the approximately 125,000 K-12 schools in the US.

In the third quarter, we completed the introduction of 30 minute protocols for all of our products. Most of our products have historically required use for at least 50 minutes each day for a period of eight to 12 weeks; these new protocols are designed for use 30 minutes per day, over a longer overall time period. The limited availability of time and computers in schools is an obstacle to use of our products. This new option will provide schools with increased flexibility in implementing the Fast ForWord products.

Sales of our products are included in the growing supplemental education materials segment of the overall education materials market. The most recent annual survey summarized in Education Market Research's *Complete K-12 Report* estimates that the total market for K-12 supplemental instructional materials in the United States is $2.2 billion, up from $1.4 billion in the 1998/99 school year. Between 1998/99 and 2005/06, this market had an average annual growth rate of 6.8%. In addition, educational software sales are expected to grow over the long-term in the range of 7% to 9% per year. Education Market Research's *Complete K-12 Newsletter* estimated the market for all educational software at approximately $800 million for the 2004/05 school year. The educational materials market is expected to continue to grow, driven by increasing enrollment of pre-K-12 students, performance and educator accountability requirements of federal legislation, and a projected increase in current expenditures per student.

Federal education funds are a critical resource in helping school districts address the needs of the most challenged learners. We believe that a significant proportion of our sales are funded by federal sources, particularly Title One and IDEA (special education) grants. In fiscal 2007, the federal government appropriated $10.8 billion to state grants for special education and $12.8 billion to Title One grants to local education agencies.

Company Highlights

For the three months ended September 30, 2007, our total booked sales increased by 15% over the same period in 2006, and for the nine months ended September 30, 2007 our total booked sales increased by 15% over the same period in 2006. (Booked sales is a non-GAAP financial measure. For more explanation on booked sales, see *Booked Sales and Selling Activity,* below). Booked sales for the quarter were below our expectations.

Our long-term target annual growth rate for revenue and booked sales is 20%-25%.

For the three months ended September 30, 2007, we closed 37 transactions in excess of $100,000, compared to 30 in the third quarter of 2006. One of our major goals is to increase the number of large, over $100,000 booked sales transactions, which we believe to be an important indicator of education industry acceptance of our products and critical to achieving our booked sales targets. These large transactions frequently require school board approvals and their timing is often difficult to predict.

For the three months ended September 30, 2007, our total revenue increased by 14% compared to the same period in 2006 and for the nine months ended September 30, 2007, our total revenue increased by 13% compared to the same period in 2006. Revenue was below our expectations for the quarter. Product revenue was up by 6% and 5% in the three and nine months periods ended September 30 2007, respectively, compared to the same periods in 2006. The growth of product revenues was slower than total revenues as product booked sales were below expectations. A significant factor was an increase in multiple year service and support packages in our second and third quarter sales mix which include a lower proportion of product. Service and support revenue increased by 33% and 38%, respectively, in the three and nine months periods ended September 30 2007, due to an increase in services delivered and a higher number of schools on support.

For the three and nine months ended September 30, 2007, gross profit increased by 22% and 16% respectively over the comparable periods in the prior year, mainly due to improvement in service and support margins. Operating expenses were higher in the three and nine month periods ended September 30, 2007 as compared to the same periods in 2006, mostly due to headcount growth, primarily in sales and marketing. In the nine months ended September 30, 2007 we incurred approximately $614,000 in legal, accounting, printing and travel costs related to our secondary stock offering. Approximately $289,000 of these costs were incurred in the third quarter.

At September 30, 2007 and 2006 we had no outstanding debt.

Results of Operations

Revenues

	Three Months Ended September 30,			Nine Months Ended September 30,		
(dollars in thousands)	**2007**	***Change***	**2006**	**2007**	***Change***	**2006**
Products	$ 7,456	*6%*	$ 7,006	$ 23,935	*5%*	$ 22,882
Service and support	3,894	*33%*	$ 2,919	10,805	*38%*	$ 7,827
Total revenues	$ 11,350	*14%*	$ 9,925	$ 34,740	*13%*	$ 30,709

Product revenues, which comprise the majority of our revenue, increased modestly during the three and nine months ended September 30, 2007, compared to the same periods in 2006. The growth in product revenues was slower than total revenues due to lower than expected product booked sales, and an increase in multiple year service and support packages in our second and third quarter sales mix which include a lower proportion of product revenue.

Our service and support revenue increased significantly during the three and nine months ended September 30, 2007 compared to the same periods in 2006 due to more services delivered and a higher number of schools on support.

Booked sales and selling activity: Booked sales is a non-GAAP financial measure that management uses to evaluate current selling activity. We believe that booked sales is a useful metric for investors as well as management because it is the most direct measure of current demand for our products and services. Booked sales equals the total value (net of allowances) of software, services and support invoiced in the period. We record booked sales and deferred revenue when all of the requirements for revenue recognition have been met, other than the requirement that the revenue for software licenses and services has been earned. We use booked sales information for resource allocation, planning, compensation and other management purposes. We believe that revenue is the most comparable GAAP measure to booked sales. However, booked sales should not be considered in isolation from revenues, and is not intended to represent a substitute measure of revenues or any other performance measure calculated under GAAP.

The following reconciliation sets forth our booked sales, revenues and change in deferred revenue for the three and nine months ended September 30, 2007 and 2006:

	Three Months Ended September 30,			**Nine Months Ended September 30,**		
(dollars in thousands)	**2007**	***Change***	**2006**	**2007**	***Change***	**2006**
Booked sales	$ 14,535	*15%*	$ 12,686	$ 39,856	*15%*	$ 34,710
Less: revenue	11,350	*14%*	9,925	34,740	*13%*	30,709
Net increase in deferred revenue	3,185		2,761	5,116		4,001
Total deferred revenue end of period	$ 24,275	*16%*	$ 21,004	$ 24,275	*16%*	$ 21,004

Booked sales in the K-12 sector increased by 8% to $13.0 million during the three months ended September 30, 2007, and by 13% to $36.4 million for the nine months ended September 30, 2007, compared to the same periods in 2006. The characteristics of our public school market cause us to have a potentially long and unpredictable sales cycle.

Booked sales in the K-12 sector for the three and nine months ended September 30, 2007 were respectively 90% and 91% of total booked sales, compared to 95% and 93% in the same periods in 2006. Booked sales to non-school customers increased by 120% for the three months and 40% for the nine months ended September 30, 2007, compared to the same periods in the previous year. A significant portion of the increase is due to a $668,000 transaction in the juvenile corrections market, closed by our direct sales force.

We believe sales transactions greater than $100,000 are an important indicator of mainstream education industry acceptance of our products and an important factor in reaching our goal of increasing sales force productivity. During the third quarter of 2007, we closed 37 sales that had a contract value in excess of $100,000 compared to 30 during the same period in 2006. For the three months and nine months ended September 30, 2007, approximately 66% and 67%, respectively, of our K-12 booked sales were realized from transactions valued at over $100,000. For the comparable periods in 2006, these large booked sales accounted for approximately 73% and 74%, respectively, of booked sales. Large booked sales include volume and negotiated discounts but the percentage discount applicable to any given transaction will vary and the relative percentage of large booked sales and smaller booked sales in a given quarter may fluctuate. Because we discount product license fees but do not discount service and support fees, product booked sales and revenue are disproportionately affected by discounting. We cannot predict the size and number of large transactions in the future.

Although federal, state and local budget pressures make for an uncertain funding environment for our customers, we remain optimistic about our growth prospects in the K-12 market. However, achieving our booked sales growth objectives will depend on increasing customer acceptance of our products, which requires us to continue to focus on improving our products' ease of use, their fit with school requirements, and our connection with classroom teachers and administrators. Our K-12 growth prospects are also influenced by factors outside our control, including the overall level, certainty and allocation of state, local and federal funding. In addition, the revenue recognized from our booked sales can be unpredictable. Our various license and service packages have substantially differing revenue recognition periods, and it is often difficult to predict which license package a customer will purchase, even when the amount and timing of a sale can be reasonably projected. See "*Management's*

Discussion and Analysis – Application of Critical Accounting Policies" for a discussion of our revenue recognition policy. In addition, the timing of a single

large order or its implementation can significantly impact the level of booked sales and revenue at any given time. See *“Risk Factors”* for a further discussion of some of the factors that affect our sales and revenue.

Gross Profit and Cost of Revenues

	Three Months Ended September 30,		Nine Months Ended September 30,	
(dollars in thousands)	**2007**	**2006**	**2007**	**2006**
Gross profit on products	$ 6,997	$ 6,573	$ 22,676	$ 21,600
Gross profit margin on products	*94%*	*94%*	*95%*	*94%*
Gross profit on service and support	2,022	830	4,592	1,911
Gross profit margin on services and support	*52%*	*28%*	*42%*	*24%*
Total gross profit	$ 9,019	$ 7,403	$ 27,268	$ 23,511
Total gross profit margin	*79%*	*75%*	*78%*	*77%*

The overall gross profit margin increased for the three and nine months ended September 30, 2007 compared to the same periods in 2006. The increase in gross margins in the three months ended September 30, 2007 was driven primarily by increased service and support margins, partially offset by a reduction in the percent of higher margin product revenue. Service and support revenue growth of 33%, combined with a 10% decrease in service and support costs, resulted in an increase in the service and support gross margin from 28% to 52%. The main reasons for the increase in service and support gross margin were higher staff utilization and leverage from our new Tucson support center. Higher margin product revenues comprised 66% of total revenues compared to 71% in the comparable period in 2006. In the nine months ended September 30, 2007, service and support revenues increased by 38% and costs by only 5%, resulting in an 18% improvement in service and support gross margins. This was partially offset by reduction in higher margin product revenue which was 69% of revenue for the nine months ended September 30, 2007 compared to 75% for the nine months ended September 30, 2006.

Operating Expenses

	Three Months Ended September 30,			Nine Months Ended September 30,		
(dollars in thousands)	**2007**	***Change***	**2006**	**2007**	***Change***	**2006**
Sales and marketing	$ 6,143	*21%*	$ 5,084	$ 18,745	*18%*	$ 15,906
Research and development	1,016	*-4%*	1,057	3,385	*7%*	3,170
General and administrative	1,890	*3%*	1,837	5,721	*14%*	5,035
Total operating expenses	$ 9,049	*13%*	$ 7,978	$ 27,851	*16%*	$ 24,111

Sales and Marketing Expenses: For the three and nine months ended September 30, 2007, our sales and marketing expenses increased by 21% and 18%, respectively, compared to the same periods in 2006. These increases are mainly due to higher employee costs, as headcount has increased by 11% year over year, and to increased spending on marketing initiatives. At September 30, 2007, we had 50 quota-bearing field sales personnel compared to 42 at September 30, 2006.

Research and Development Expenses: For the three months ended September 30, 2007, our research and development expenses decreased by 4%, compared to the same period in 2006 and for the nine months ended September 30, 2007 our research and development expenses increased by 7%. The decrease for the third quarter is primarily the result of reversals of accruals for management and employee bonuses of $93,000, partially offset by higher employee and outsourced development costs. The increased costs for the nine months ended September 30, 2007 are due to higher outsourced development costs, which were only partially offset by the reduced bonus expenses. Research and development expenses principally consist of compensation paid to employees and consultants engaged in research and product development activities and product testing, together with software and equipment costs.

General and Administrative Expenses: For the three and nine months ended September 30, 2007, our general and administrative expenses increased by 3% and 14%, respectively, compared to the same periods in 2006. The primary reason for the increase is that in the nine months ended September 30, 2007 we incurred approximately $614,000 in

legal, accounting, printing and travel costs related to our secondary stock offering. Approximately $289,000 of these costs were incurred in the third quarter. These costs were partially offset in the third quarter by reversals of accruals for management and employee bonuses of $144,000.

Other Income from Related Party

In September 2003, we signed an agreement with Posit Science Corporation ("PSC"), transferring technology to PSC for use in the health field. During the three and nine month periods ending September 30, 2007, we recorded $68,000 and $185,000, respectively, in royalty income from PSC. For the comparable three and nine month periods in 2006, we recorded $38,000 and $112,000, respectively, in royalty income. Amounts received to date and any future receipts are being reported as other income as we do not consider these royalties to be part of our recurring operations.

Interest and Other Income

	Three Months Ended September 30,			Nine Months Ended September 30,		
(dollars in thousands)	**2007**	***Change***	**2006**	**2007**	***Change***	**2006**
Interest and other income, net	$ 230	*20%*	$ 192	$ 701	*89%*	$ 370

For the three months ended September 30, 2007, interest and other income consisted primarily of interest earned on our invested cash of $144,000 and a reclassification of $85,000 of service and support revenue relating to two customers for whom we are no longer performing services. In the three months ended September 30, 2006, interest and other income comprised mainly interest earned on our invested cash of $136,000, and a reclassification of $55,000 of service and support revenue relating to the two customers for whom we are no longer performing services. Accounting principles require that when we are no longer performing services for a customer, previously deferred revenue related to contracted services be recognized as other income rather than revenue.

For the nine months ended September 30, 2007, interest and other income consisted primarily of interest earned on our invested cash of $435,000 and a reclassification of $259,000 of service and support revenue relating to two customers for whom we are no longer performing services. In the nine months ended September 30, 2006, interest and other income comprised mainly interest earned on our invested cash of $308,000 and a reclassification of $55,000 of service and support revenue relating to the two customers for whom we are no longer performing services.

Provision for Income Taxes

In the nine months ended September 30, 2007, we recorded an income tax provision of $26,000 based on our expectation that we will be profitable for the fiscal year. For the nine months ended September 30, 2006, we did not record any tax provision. The tax provision principally consists of federal and state taxes currently payable offset by the utilization of net operating losses resulting in an effective tax rate, excluding discrete items, of approximately 7.12%. In the three months ended September 30, 2007, we recorded an income tax provision of $22,000, resulting in a period tax rate of approximately 8.30%. Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS 109") provides recognition of deferred tax assets if realization of such assets in more likely than not. Based upon the weight of available evidence, which includes historical operating performance and previously reported net losses, we continue to maintain a full valuation allowance against our remaining net deferred tax assets. As a result of the change of control triggered by our secondary offering in July 2007, the utilization of our net operating losses will be limited in future periods.

Effective January 1, 2007, we adopted Financial Accounting Standards Interpretation, or FIN, No. 48, "Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109." FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of uncertain tax positions taken, or expected to be taken, in a company's income tax return; and also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN No. 48 utilizes a two-step approach for evaluating uncertain tax positions accounted for in accordance with SFAS No. 109. Step one, recognition, requires a company to determine if the weight of available evidence indicates that a tax position is more likely than not to be sustained upon audit, including resolution of related appeals or litigation processes, if any. Step two, measurement, is based on the largest amount of benefit, which is more likely than not to be realized on ultimate

settlement. The cumulative effect of adopting FIN No. 48 on January 1, 2007 is recognized as a change in accounting principle, recorded as an adjustment to the opening balance of retained earnings on the adoption date.

As a result of the implementation of FIN No. 48, we did not recognize any increase or decrease in the liability for unrecognized tax benefits related to tax positions taken in prior periods, therefore, there was no corresponding adjustment in retained earnings. Additionally, FIN 48 specifies that tax provisions for which the timing of the ultimate resolution is uncertain should be recognized as long-term liabilities. For the three month period ending September 30, 2007, we reclassified $24,000 between current and long term taxes payable and made no such reclassifications upon adoption of FIN 48. Our total unrecognized tax benefits as of the January 1, 2007 adoption date and September 30, 2007 was $1.4 million and $1.8 million respectively. We have approximately $24,000 of unrecognized tax benefits that, if recognized, would affect our current effective tax rate.

Our continuing practice is to recognize interest and penalties relating to income tax matters in income tax expense. We recorded approximately $5,000 of such expense in the three month period ended September 30, 2007, and had no accruals prior to the September 30, 2007 period.

Liquidity and Capital Resources

Our cash and cash equivalents were $19.9 million at September 30, 2007, compared to $16.4 million at December 31, 2006 and to $13.3 million at September 30, 2006. We expect that our cash flow from operations and our current cash balances will be the primary source of liquidity and will be sufficient to provide the necessary funds for our operations and capital expenditures during at least the next 12 months. Accomplishing this, however, will require us to meet specific booked sales targets in the K-12 market. We cannot assure you that we will meet our targets with respect to booked sales, revenues, expenses or operating results.

We have a line of credit currently available through December 2, 2008 with Comerica Bank totaling $5.0 million. The line is subject to limitations based on our quick ratio and tangible net worth. Borrowings under the line are subject to various covenants, which may limit our financial and operating flexibility. At September 30, 2007, there were no borrowings outstanding under the line, other than an outstanding letter of credit for $0.2 million. As of September 30, 2007, we were in compliance with all our covenants.

If we are unable to achieve sufficient cash flow from operations, we may seek other sources of debt or equity financing, or may be required to reduce expenses. Reducing our expenses could adversely affect operations by reducing the resources available for sales, marketing, research or product development. We cannot assure you that we will be able to secure additional debt or equity financing on acceptable terms, if at all.

Historically, our first quarter is our lowest booked sales quarter, reflecting school purchasing cycles and a trend in our industry. Therefore, we may have negative cash flow in some quarters, particularly the first quarter, and may borrow funds from time to time. We generally use cash in operations during the first quarter and this trend continued in 2007. Our second quarter is historically our highest booked sales quarter, and the timing of sales and the payment terms given determine whether we generate or use cash. In the three months ended September 30, 2007 we generated significant cash from operations, driven largely by collection of receivables from second quarter sales.

Net cash from operating activities for the nine months ended September 30, 2007 was $3.5 million compared to $1.3 million during the same period in 2006. This difference was primarily the result of increased sales, and the timing of receipts from customers.

Net cash used in investing activities for the nine months ended September 30, 2007 was $991,000, entirely due to capital spending. Net cash generated by investing activities for the nine months ended September 30, 2006 was $2.7 million, primarily due to the maturity of $3.0 million of short term investments. We also received the final payment on our outstanding officer loans during the three months ended March 31, 2006 of $213,000. Capital spending for the nine months ended September 30, 2006 was $581,000.

Financing activities generated $1.0 million for the nine months ended September 30, 2007, compared to $335,000 for the nine months ended September 30, 2006, from proceeds from option exercises and the employee stock purchase plan.

For the nine months ended September 30, 2007 and September 30, 2006 we had no borrowings.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements.

Contractual Obligations and Commitments

We have a non-cancelable lease agreement for our corporate office facilities. The minimum lease payment is approximately $78,000 per month through 2008. After 2008 the base lease payment increases at a compound annual rate of approximately 5%. The lease terminates in December 2013. We also have a lease agreement for our Tucson, Arizona office through April 2009 at an average rent of approximately $4,500 per month for the period subsequent to January 1, 2007.

We also make royalty payments to the institutions that participated in the original research that produced our initial products. Our minimum royalty payments are $150,000 per year.

The following table summarizes our obligations at September 30, 2007 and the effects such obligations are expected to have on our liquidity and cash flow in future periods (dollars in thousands):

(dollars in thousands)	Total	Less than 1 year	2 - 3 years	4 - 5 years	Thereafter
Contractual Obligations:					
Operating lease obligations	$ 6,669	$ 995	$ 2,025	$ 2,185	$ 1,464
Purchasing obligations	1,088	150	300	300	338
Total	$ 7,757	$ 1,145	$ 2,325	$ 2,485	$ 1,802

Our purchase order commitments at September 30, 2007 are not material.

Application of Critical Accounting Policies

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States ("GAAP"). These accounting principles require us to make certain estimates, assumptions and judgments. We believe that the estimates, assumptions and judgments upon which we rely are reasonable based upon information available to us at the time. The estimates, assumptions and judgments that we make can affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amounts of revenues and expenses during the periods presented. To the extent there are material differences between these estimates and actual results, our financial statements would be affected.

We believe that the estimates, assumptions and judgments pertaining to revenue recognition, allowance for doubtful accounts, software development costs and long-lived assets are the most critical assumptions to understand in order to evaluate our reported financial results. A detailed discussion of our use of estimates, assumptions and judgments as they relate to these polices is presented below. We have discussed the application of these critical accounting policies with the Audit Committee of the Board of Directors.

Revenue Recognition

We derive revenue from the sale of licenses to our software and from service and support fees. Software license revenue is recognized in accordance with AICPA Statement of Position 97-2, "*Software Revenue Recognition*," as amended by Statement of Position 98-9 (SOP 97-2). SOP 97-2 provides specific industry guidance and four basic criteria, which must be met to recognize revenue. These are: 1) persuasive evidence of an arrangement exists; 2) delivery of the product has occurred; 3) a fixed or determinable fee; and 4) the probability that the fee will be collected. The application of SOP 97-2 requires us to exercise significant judgment related to our specific transactions and transaction types.

Sales to our school customers typically include multiple elements (e.g., Fast ForWord software licenses, Progress Tracker, our Internet-based participant tracking service, support, training, implementation management, and other services). We allocate revenue to each element of a transaction based upon its fair value as determined in reliance on "vendor specific objective evidence" ("VSOE"), if VSOE exists for each element. As we do not have VSOE for software licenses, we normally recognize revenue using the residual method on arrangements with multiple elements that include software licenses, whereby the difference between the total arrangement fee and the total fair value of the undelivered elements (generally services and support) is recognized as revenue relating to software licenses. VSOE of fair value for each element of an arrangement is based upon the normal pricing and discounting practices for those products and services when sold separately and, for support services, is also measured by the renewal price. We are required to exercise judgment in determining whether VSOE exists for each undelivered element based on whether our pricing for these elements is sufficiently consistent.

The value of software licenses, services and support invoiced during a particular period is recorded as deferred revenue until recognized. All revenue from transactions that include new products that have not yet been delivered is deferred until the delivery of all products. Deferred revenue is recognized as revenue as discussed below.

Product revenue

Product revenue is primarily derived from the licensing of software and is recognized as follows:

Perpetual licenses – software licensed on a perpetual basis. Revenue is recognized at the later of product delivery date or contract start date using the residual method. If VSOE does not exist for all the undelivered elements, all revenue is deferred and recognized ratably over the service period if the undelivered element is services or when all elements have been delivered.

Term licenses – software licensed for a specific time period, generally three to twelve months. Revenue is recognized ratably over the license term.

Individual participant licenses – software licensed for a single participant. Revenue is recognized over the average period of use, typically six weeks.

Service and support revenue

Service and support revenue is derived from a combination of training, implementation, technical and professional services, online services and customer support. Training, technical and other professional services are typically sold on a per day basis. If VSOE exists for all elements of an arrangement or all elements except software licenses, services revenue is recognized as performed. If VSOE does not exist for all the elements in an arrangement except software licenses, service revenue is recognized over the longest contractual period in an arrangement. Revenue from services sold alone or with support is recognized as performed.

Allowance for Doubtful Accounts

We maintain an allowance for doubtful accounts for estimated losses due to the inability of customers to make payments. We adjust this allowance periodically based on our historical experience of bad debt write offs, which have been low in recent years. Cancellations and refunds are allowed in limited circumstances, and such amounts have not been significant.

Income Taxes

We account for income taxes using the liability method, which requires the recognition of deferred tax assets or liabilities for the tax-effected temporary differences between the financial reporting and tax bases of our assets and liabilities and for net operating loss and tax credit carryforwards. We have recorded a full valuation allowance to reserve for the benefit of our deferred tax assets due to the uncertainty surrounding our ability to realize these assets.

Effective January 1, 2007, we adopted Financial Accounting Standards Interpretation, or FIN, No. 48, "Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109." FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of uncertain tax positions taken, or expected to be taken, in a company's income tax return; and also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN No. 48 utilizes a two-

step approach for evaluating uncertain tax positions accounted for in accordance with SFAS No. 109. Step one, recognition, requires a company to determine if the weight of available evidence indicates that a tax position is more likely than not to be sustained upon audit, including resolution of related appeals or litigation processes, if any. Step two, measurement, is based on the largest amount of benefit, which is more likely than not to be realized on ultimate settlement. The cumulative effect of adopting FIN No. 48 on January 1, 2007 is recognized as a change in accounting principle, recorded as an adjustment to the opening balance of retained earnings on the adoption date. As a result of the implementation of FIN No. 48, we did not recognize any increase or decrease in the liability for unrecognized tax benefits related to tax positions taken in prior periods, therefore, there was no corresponding adjustment in retained earnings.

Stock-Based Compensation

Under the fair value recognition provisions of SFAS No. 123R, we use the Black-Scholes option valuation model to estimate stock-based compensation expense at the grant date based on the fair value of the award and recognize the expense ratably over the requisite service period of the award. Determining the appropriate fair value model and assumptions used in calculating the fair value of stock-based awards requires judgment, including estimating stock price volatility, forfeiture rates and expected life. Stock compensation expense may be adjusted in the future if actual forfeiture rates differ significantly from our current estimates.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Risk

Our exposure to market risk for changes in interest rates relates primarily to the rate of interest that we earn on our cash and cash equivalents. A hypothetical increase or decrease in market interest rates by 10% from the market interest rates at September 30, 2007 would not have a material affect on our results of operations.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Disclosure controls and procedures are designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is recorded, processed, summarized and reported within the required time periods. These procedures are also designed to ensure that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

As required under Rule 13a-15(b) of the Exchange Act, our management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of the Company’s disclosure controls and procedures as of the end of the period covered by this report, and concluded that our disclosure controls and procedures were effective as of September 30, 2007.

It should be noted that a control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. As a result, there can be no assurance that a control system will succeed in preventing all possible instances of error and fraud. Our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives, and the conclusions of our Chief Executive Officer and the Chief Financial Officer are made at the “reasonable assurance” level.

Changes in Internal Controls over Financial Reporting

There were no changes in our internal control over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In September 2007, we received a demand letter from one of our field sales representatives seeking approximately $423,000 in additional commissions relating to a sale in the quarter ended June 30, 2007. Under the applicable incentive compensation plan, our management may reduce the commission for certain large sales if certain conditions are met. We believe those conditions were met and, therefore, reduced the respective commission. The claimant contends that we did not have the right to reduce the commission in these circumstances.

We believe that these claims are not meritorious and that we do not have any significant liability to this sales representative for additional commissions. We therefore do not believe that the resolution of this matter will have a material adverse effect on our financial position or results of operations.

Item 1A. Risk Factors

RISK FACTORS

The following factors as well as other information contained in this report should be considered in making any investment decision related to our common stock. If any of the following risks actually occurs, our business, financial condition and results of operations could be materially and adversely affected and the trading price of our common stock could decline.

To grow our business, we need to increase acceptance of our products among K-12 education purchasers. Failure to do so would materially and adversely impact our revenue, profitability and growth prospects.

We believe that to date most educators who have used *Fast ForWord* products are “early adopters.” Early adopters make up a relatively small proportion of our K-12 market, so in order to grow our revenue and profit, we need to increase our reach beyond early adopters to more conservative customers. We believe that our ability to grow acceptance of our products in the conservative K-12 education market will depend largely on the critical factors discussed below.

Our *Fast ForWord* products use an approach that differs from the approaches that schools have traditionally used to address reading problems. In particular, our products work because they increase learning capacity, are based on neuroscience research and focus on the development of cognitive skills. All of these concepts may be unfamiliar to educators. K-12 educational practices are slow to change, and it can be difficult to convince educators of the value of a substantially different approach.

In order to obtain the best student results from using our product, schools must follow a recommended protocol for *Fast ForWord* use, which requires a substantial amount of time out of a limited and already crowded school day. Our recommendation that schools follow a prescribed protocol in using our products may limit the number of schools willing to purchase from us. In addition, if our products are not used in accordance with the protocol, they may not produce the expected student results, which may lead to customer dissatisfaction and decreased revenue.

Our products are generally implemented in a computer lab with a lab coach or teacher rather than in the classroom with the students’ regular classroom teachers. To reach a broader group of customers, encourage additional sales from existing customers and improve student achievement results, we need to better engage classroom teachers in the products’ implementation, in an effective and efficient manner.

We encourage our customers to purchase significant levels of on-site service because we believe that these services enable more effective product use and lead to stronger student achievement gains. If we are unable to continue to convince customers to purchase these levels of service, customers may experience more difficulty with their implementations.

If we are unable to convince our market of the value of our significantly different approach and otherwise overcome the challenges identified above, our revenue and growth prospects could be materially and adversely impacted and our profit could decline.

Our sales cycle tends to be long and somewhat unpredictable, which may result in delayed or lost revenue, which could materially and adversely impact our revenue and profitability.

Like other companies in the instructional market, our sales to K-12 schools are affected by school purchasing cycles and procedures, which can be quite bureaucratic. The cost of some of our K-12 license packages requires multiple levels of approval in a political environment, which results in a time-consuming sales cycle that can be difficult to predict. When a district decides to finance its license purchase, the time required to obtain necessary approvals can be extended even further. In addition, sales to schools are subject to budgeting constraints, which may require schools to find available discretionary funds, obtain grants or wait until subsequent budget cycles. As a result, our sales cycle generally takes months, and in some cases, can take a year or longer. Therefore, we may devote significant time and energy to a particular customer sale over the course of many months, and then not make the sale when expected or at all. This can result in lost opportunities that can materially and adversely impact our revenue and profit.

It is difficult to accurately forecast our future financial results. This may cause us to fail to achieve the financial performance anticipated by investors and financial analysts, which could cause the price of our stock to decline.

Our revenue and net income or loss are difficult to predict and may fluctuate substantially from quarter to quarter as a result of many factors, including those discussed below.

A significant proportion of our customers' purchases are made within the last two weeks of each quarter. We therefore have limited visibility on revenue for the quarter until the end of the quarter. If a customer unexpectedly postpones or cancels an expected purchase due to changes in the customer's objectives, priorities, budget or personnel, we may experience an unexpected shortfall that cannot be made up in the quarter. The effect of the concentration of sales at the end of the quarter is compounded by the fact that our various license and service packages have substantially differing revenue recognition periods. Even when the amount and timing of a transaction can be accurately projected, it may be difficult to predict which license package a customer will purchase.

Our quarterly revenue from perpetual licenses became more unpredictable in 2006 than in prior years. Since our December 2004 pricing change, we recognize revenue from most of our perpetual license sales at the time of sale. In addition to the variability in revenue recognition timing from our different license and service packages, this has resulted in a more seasonal revenue pattern. Before the pricing change, perpetual license revenue was recognized over the related service period and was somewhat more predictable.

In addition, our sales strategy emphasizes district-level, multi-site transactions. The receipt or implementation of a single large order, or conversely its loss or delay, can significantly impact the level of sales booked and revenue recognized in a given quarter. For example, for our fiscal quarter ended June 30, 2007, we recorded booked sales of over $7 million for one transaction, which represented approximately 38% of our booked sales for that quarter. Without that transaction, our booked sales for the quarter ended June 30, 2007 would have decreased relative to the quarter ended June 30, 2006 rather than increase by 28%.

Our expense levels are based on our expectations of future revenue and are primarily fixed in the short term. We may not be able to adjust spending in a timely manner to compensate for any unexpected revenue shortfall, which could cause our net income to fluctuate unexpectedly.

Failure to achieve the financial results expected by investors and financial analysts in a given quarter could cause an immediate and significant decline in the trading price of our common stock.

Our historical profitability has been inconsistent, and our profitability levels continue to be uncertain.

We started operations in February 1996 and through 2002 incurred significant operating losses. We first became profitable in 2003, incurred a net loss in 2004, were again profitable in 2005 and had a modest operating loss and modest

net income in 2006. We incurred a net loss in the first quarter of 2007 and had net income in the second and third quarters of 2007. At September 30, 2007, we had an accumulated deficit of $77.6 million from inception.

Our strategic and operating goals include increasing our booked sales, revenue and net income. In 2006, our booked sales increased significantly over 2005 levels, when booked sales had fallen from 2004. In the first nine months of 2007, our booked sales increased 15% compared to the first nine months of 2006. Our ability to achieve increased booked sales, revenue and net income depends on many factors, including but not limited to market acceptance of our products, availability of funding, customers' prior experience with our products, and general economic conditions, some of which are outside of our control. To meet our targets, we will need to make substantial investments in operations. We cannot assure you that we will meet our targets with respect to revenue or operating results.

We rely on studies of student performance results to demonstrate the effectiveness of our products. If the validity of these studies or the conclusions that we draw from them are challenged, our reputation could be harmed and our business prospects and financial results could be materially and adversely affected.

We rely heavily on statistical studies of student results on assessments to demonstrate that our *Fast ForWord* products lead to improved student achievement. Reliance on these studies to support our claims about the effectiveness of our products involves risks, including the following:

- The results of studies depend on schools' appropriately implementing the products and adhering to the product protocol. If a school does not do so, the study may not show that our products produce substantial student improvements.
- Some studies on which we rely may be challenged because the studies use a limited sample size, lack a randomly selected control group, include assistance or participation from us or our scientists, or have other design characteristics that are not optimal. These challenges may assert that these studies are not sufficiently rigorous or free from bias, and may lead to criticism of the validity of the studies and the conclusions that we draw from them.
- Schools studying the effectiveness of our products use the product with different types of students and use different assessments, sometimes making it difficult to aggregate or compare results.

Our sales and marketing efforts, as well as our reputation, could be adversely impacted if the studies upon which we rely to demonstrate the effectiveness of our products, or the conclusions we draw from those studies, are seen to be insufficient.

If our products contain errors or if customer access to our Progress Tracker product is disrupted, we could lose new sales and be subject to significant liability claims.

Because our software products are complex, they may contain undetected errors or defects, known as bugs. Bugs can be detected at any point in a product's life cycle, but are more common when a new product is introduced or when new versions are released. In the past, we have encountered unexpected bugs in our products shortly after release. We expect that, despite our testing, errors will be found in new products and product enhancements in the future. Significant errors in our products could lead to:

- delays in or loss of market acceptance of our products;
- diversion of our resources;
- a lower rate of expansion purchases from current customers;
- injury to our reputation; and
- increased service expenses or payment of damages.

Our Progress Tracker data tool is a web-delivered product. Unanticipated problems affecting our network systems could cause interruptions or delays in the delivery of that product. The servers that support Progress Tracker are

currently located in a third-party co-location facility in Sacramento, California. While we believe that the services provided by this facility are robust, interruptions in customer access could be caused by the occurrence of a natural disaster, power loss, vandalism or other telecommunications problems. We have experienced problems due to power loss in the past, and we will continue to be exposed to the risk of access failure in the future.

If our products do not work properly, or if there are problems with customer access to Progress Tracker, we may be required to issue credits, customers may elect not to renew their support or access contracts or not to purchase additional licenses, we may lose sales to potential customers and we may be subject to liability claims. We cannot be certain that the limitations of liability set forth in our agreements would be enforceable or would otherwise protect us from liability for damages. A material liability claim against us, regardless of its merit or its outcome, could result in substantial costs, significantly harm our business reputation and divert management’s attention from our operations.

We will be required to comply with the management report requirements of Sarbanes-Oxley Section 404 as of December 31, 2007. If we are unable to comply with Section 404 when we are required to do so or are unable to conclude that our internal control over financial reporting is effective for the 2007 fiscal year, such non-compliance or ineffective controls could have a materially adverse effect on us.

Under Sarbanes-Oxley Section 404, as implemented by the SEC and PCAOB, we will be required to provide an initial management assessment on our internal control over financial reporting for fiscal 2007 and the auditors’ attestation for fiscal 2008. We have not previously been subject to this requirement.

While we evaluate our internal controls on an on-going basis, we or our auditors may nevertheless discover significant deficiencies or material weaknesses in our internal controls. For instance, in connection with our restatements in 2005, we concluded that we had a material weakness in our internal controls relating to revenue and deferred revenue. To address this material weakness, we hired additional accounting staff and we implemented changes in our processes, procedures and controls relating to revenue and deferred revenue. In connection with the audit of our financial statements for the year ended December 31, 2005, management concluded and the Audit Committee concurred that, at December 31, 2005, we no longer had a material weakness in our internal control over financial reporting. Nevertheless, we cannot assure you that, in the course of implementing our processes to achieve compliance with Section 404, we or our auditors will not detect additional material weaknesses in our internal control over financial reporting.

Claims relating to data collection from our user base may subject us to liabilities and additional expense.

Schools and clinicians that use our products frequently use students’ names to register them in our products and enter into our database academic, diagnostic and/or demographic information about the students. In addition, the results of student use of our products are uploaded to our database. We have designed our system to safeguard this personally-identifiable information, but the protection of such information is an area of increasing public concern and significant government regulation, including but not limited to the Children’s Online Privacy Protection Act. If our privacy protection measures prove to be ineffective, we could be subject to liability claims for unauthorized access to or misuses of personally-identifiable information stored in our database. We may also face additional expenses to analyze and comply with increasing regulation in this area.

Sales of our products depend on the availability of government funding for public school reading intervention purchases, which is variable and outside the control of both us and our direct customers. If such funding becomes less available, our public school customers may be unable to purchase our products and services on a scale or at prices that we anticipate, which would materially and adversely impact our revenue and net income.

United States public schools are funded primarily through state and local tax revenues, which are devoted primarily to school building costs, teacher salaries and general operating expenses. Public schools also receive funding from the federal government through a variety of federal programs, many of which target children who are poor and/or are struggling academically. Federal funds typically are restricted to specified uses.

We believe that the funding for a substantial portion of our K-12 sales comes from federal funding, in particular IDEA (special education) and Title One funding. The current federal budget deficit and competing federal priorities may impact the availability of federal education funding. A cutback in federal education funding could have a materially adverse impact on our revenue.

State and local school funding can be significantly impacted by fluctuations in tax revenues due to changing economic conditions. We expect that future levels of state and local school spending will continue to be significantly affected by the general economic conditions and outlook. A downturn in the economy that results in a significant reduction in state tax revenues could have a materially adverse impact on our revenue.

The availability of funding for instructional products like ours can also be affected by unpredictable events, such as increases in energy costs or damage due to severe weather. We believe that severe storms and spiking energy costs adversely impacted our sales in 2005. Unpredictable events of similar magnitude could adversely impact our revenue in the future.

We compete for sales with companies that have longer histories and greater resources than we do. We may not be able to compete effectively in the education market.

The market in which we operate is very competitive. While our products are highly differentiated by their neuroscience basis and their focus on building learning capacity and developing cognitive skills, we nevertheless compete vigorously for the funding available to schools. We compete not only against other software-based reading intervention products but also against print and service-based offerings from other companies and against traditional methods of teaching language and reading. Many of the companies providing these competitive offerings are much larger than we are, are more established in the school market than we are, offer a broader range of products to schools, and have greater financial, technical, marketing and distribution resources than we do. Encouraged by the No Child Left Behind Act, new competitors may enter our market segment and offer actual or claimed results similar to those achieved by our products. In addition, although traditional approaches to language and reading are fundamentally different from our approach, the traditional methods are more widely known and accepted and, therefore, represent significant competition for available funds.

If we lose key personnel or are unable to hire additional qualified personnel as necessary, we may not be able to achieve our business goals, which could materially and adversely affect our financial results and share price.

We depend on the performance of Robert Bowen, our Chairman and Chief Executive Officer, and on other senior management, sales, marketing, development, research, educational, finance and other administrative personnel with extensive experience in our industry and with our Company. Mr. Bowen's current employment agreement with us expires in June 2008. The loss of key personnel could harm our ability to execute our business strategy, which could adversely affect our financial results and share price. In addition, we believe that our future success will depend in large part on our continued ability to identify, hire, retain and motivate highly skilled employees who are in great demand. We cannot assure you that we will be able to do so.

Our current liquidity resources may not be sufficient to meet our needs.

We believe that cash flow from operations will be our primary source of funding for our operations during 2007 and the next several years. In 2006, we generated $4.3 million in cash from operating activities, and we ended the year with $16.4 million in cash and equivalents. In 2005, we used $2.1 million in cash in our operating activities, reflecting the decline in our booked sales from 2004 and higher expenses to support our growth goals. In the nine months ended September 30, 2007, we generated cash from operating activities of $3.5 million, compared to $ 1.3 million in the nine months ended September 30, 2006. As of September 30, 2007, we had $ 19.9 million in cash and cash equivalents.

In addition, we have a line of credit with Comerica Bank totaling $5.0 million, which expires on December 30, 2008. At September 30, 2007 no borrowings were outstanding and we were in compliance with the covenants of that line.

Funding our liquidity needs out of cash flow from operations will require us to achieve certain levels of booked sales and expenses. If we are unable to achieve sufficient levels of cash flow from operations, or are unable to obtain waivers or amendments from Comerica in the event we do not comply with our covenants, we would be required either to obtain debt or equity financing from other sources, or to reduce expenses. Reducing our expenses could adversely affect our operations by reducing the resources available for sales, marketing, research or development efforts. We cannot assure you that we will be able to secure additional debt or equity financing on acceptable terms, if at all.

If we are unable to maintain our access to the intellectual property rights that we license from third parties, our sales and net income will be materially and adversely affected.

Our most important products are based on licensed inventions owned by the University of California and Rutgers, the State University of New Jersey. In 2006, we generated approximately 76% of our booked sales from products that use this licensed technology. If we were to lose our rights under these licenses (whether through expiration of our exclusive license period, expiration of the underlying patent's exclusivity, invalidity or unenforceability of the underlying patents, a breach by us of the terms of the license agreements or otherwise), such a loss of these licensed rights or a requirement that we must re-negotiate these licenses could materially harm our booked sales, our revenue and our net income.

If we are unable to adequately protect our intellectual property rights or if we infringe on the rights of others, we could become subject to significant liabilities, need to seek licenses or lose our rights to sell our products.

Our ability to compete effectively depends in part on whether we are able to maintain the proprietary aspects of our technology and to operate without infringing on the proprietary rights of others. It is possible that our issued patents will not offer sufficient protection against competitors with similar technology, that our trademarks will be challenged or infringed by competitors, or that our pending patent applications will not result in the issuance of patents. Issued patents can prove to be invalid or unenforceable as a result of a variety of reasons, including deficiencies in prosecution. As a result of potential deficiencies during the prosecution of certain patents to which we have rights, it is possible that these patents may be subject to a claim of unenforceability or invalidity. If others are able to develop similar products due to the expiration, unenforceability or invalidity of the underlying patents, the resulting competition could materially harm our booked sales, revenue and net income. The Company also typically does not register its copyrights in the United States, which may make it difficult to collect damages from a third party that may be infringing a Company copyright. The degree of future protection for our proprietary rights is also uncertain for products or product improvements in early-stage development, because it is difficult to predict from early-stage development efforts which product(s) will ultimately be marketed or what form the ultimately marketed product(s) will take.

In addition, we could become party to patent or trademark infringement claims, litigation or interference proceedings. These proceedings could result from claims that we are violating the rights of others or may be necessary to enforce our own rights. Any such proceedings would result in substantial expense and significant diversion of management effort, and the outcome of any such proceedings cannot be accurately predicted. An adverse determination in such proceedings could subject us to significant liabilities or require us to seek licenses from third parties, which may not be available on commercially reasonable terms or at all. In addition, competitors may design around our technology or develop competing technologies. Intellectual property rights may also be unavailable or limited in some foreign countries, which could make it easier for competitors to capture or increase their market share with respect to related technologies.

We generally require the execution of a written licensing agreement, which restricts the use and copying of our software products. However, if unauthorized copying or misuse were to occur to a substantial degree, our sales could be adversely affected.

The export of some of our products was not made in compliance with applicable export control regulations, and as a result we may be subject to fines and penalties.

In September 2006, we began shipping a new version of our Fast ForWord products that uses limited encryption features. Such software is subject to U.S. export control regulations and requires a one-time review from the Bureau of Industry and Security, or BIS, of the U.S. Department of Commerce to obtain authorization to ship the product outside of the United States and Canada. Although we made the required filing on May 8, 2007 and received approval on May 31, 2007, our exports of this product between September 2006 and May 4, 2007 were not made in compliance with the regulations. We have voluntarily reported this violation to BIS. BIS can assess monetary fines and penalties for each export made in violation of the regulations. Although we do not expect that any fines or penalties imposed on us will be material, we cannot assure you that the actual amount of such fines and penalties, if any, will not have a material adverse effect on our financial condition.

Our ability to utilize our net operating loss carryforwards may be limited.

Our federal net operating loss carryforwards are subject to limitations on how much may be utilized on an annual basis. The use of the net operating loss carryforwards is expected to have additional limitations resulting from certain future ownership changes or other factors under Section 382 of the Internal Revenue Code.

If our net operating loss carryforwards are further limited, and we have taxable income which exceeds the available net operating loss carryforwards for that period, we would incur an income tax liability even though net operating loss carryforwards may be available in future years prior to their expiration, and our future cash flow, financial position and financial results may be negatively impacted. . As a result of the change of control triggered by our secondary offering in July 2007, the utilization of our net operating losses will be limited in future periods.

Our common stock is thinly traded and its price is volatile.

Our common stock presently trades on the Nasdaq Global Market, and our trading volume is low. For example, during the nine months ended September 30, 2007, our average daily trading volume was approximately 13,900 shares. The market price of our common stock has been highly volatile since we became publicly traded and could continue to be subject to wide fluctuations.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit No.	Description of Document
3.1(1)	Amended and Restated Certificate of Incorporation.
3.2 (2)	Amended and Restated Bylaws
3.3 (2)	Certificate of Amendment to Amended and Restated Certificate of Incorporation
31.1	Certification of Chief Executive Officer (Section 302).
31.2	Certification of Chief Financial Officer (Section 302).
32.1	Certification of Chief Executive Officer (Section 906).
32.2	Certification of Chief Financial Officer (Section 906).

(1) Incorporated by reference to exhibit previously filed with the Company's Form 10-Q for the quarter ended March 31, 2007, file no. 000.2457.

(2) Incorporated by reference to exhibits previously filed with the Company's Amendment No. 1 to Registration Statement on Form S-1 filed July 13, 2007, registration no. 333-143093.

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.

Dated: November 5, 2007

SCIENTIFIC LEARNING CORPORATION
(Registrant)

/s/ Jane A. Freeman

Jane A. Freeman
Chief Financial Officer
(Authorized Officer and Principal Financial and Accounting Officer)

Index to Exhibits

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