Consolidated Communications Holdings, Inc.
Form DEF 14A
April 11, 2006

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
SCHEDULE 14A
(Rule 14a-101)
INFORMATION REQUIRED IN PROXY STATEMENT
SCHEDULE 14A INFORMATION
PROXY STATEMENT PURSUANT TO SECTION 14(A) OF THE SECURITIES EXCHANGE ACT OF 1934

Filed by the Registrant þ
Filed by a Party other than the Registrant o
Check the appropriate box:

o Preliminary Proxy Statement

o Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))

þ Definitive Proxy Statement
o Definitive Additional Materials
o Soliciting Material Pursuant to Rule 14a-12

Consolidated Communications Holdings, Inc.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

þ No fee required.

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(1) Amount Previously Paid:

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CONSOLIDATED COMMUNICATIONS HOLDINGS, INC.
NOTICE OF ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD MAY 18, 2006

To Our Stockholders:

The 2006 annual meeting of stockholders of Consolidated Communications Holdings, Inc. will be held at our corporate headquarters, 121 South 17th Street, Mattoon, Illinois 61938 on Thursday, May 18, 2006, at 9:00 a.m., central time. The 2006 annual meeting of stockholders is being held for the following purposes:

1. To elect one Class I director, for a term of three years, in accordance with our amended and restated certificate of incorporation and amended and restated bylaws (Proposal No. 1);

2. To ratify the appointment of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2006 (Proposal No. 2); and

3. To transact such other business as may properly come before the annual meeting and any adjournment or postponement thereof.

Only stockholders of record at the close of business on March 29, 2006 are entitled to vote at the meeting or at any postponement or adjournment thereof.

We hope that as many stockholders as possible will personally attend the meeting. Whether or not you plan to attend the meeting, please complete the enclosed proxy card and sign, date and return it promptly so that your shares will be represented. Sending in your proxy will not prevent you from voting in person at the meeting.

By Order of the Board of Directors,

Steven J. Shirar
Senior Vice President, President of
Enterprise Operations and Secretary

April 13, 2006

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CONSOLIDATED COMMUNICATIONS HOLDINGS, INC.
121 South 17th Street
Mattoon, Illinois 61938

PROXY STATEMENT

This proxy statement contains information related to the 2006 annual meeting of stockholders of Consolidated Communications Holdings, Inc., a Delaware corporation (the Company, Consolidated, we or us) that will be held a our corporate headquarters, 121 South 17th Street, Mattoon, Illinois 61938 on Thursday, May 18, 2006, at 9:00 a.m., central time, and at any postponements or adjournments thereof. The approximate date of mailing for this proxy statement, proxy card, as well as a copy of our combined 2005 annual report to stockholders and annual report on Form 10-K for the year ended December 31, 2005, is April 13, 2006.

ABOUT THE MEETING

What is the purpose of this proxy statement?

The purpose of this proxy statement is to provide information regarding matters to be voted on at the 2006 annual meeting of our stockholders. Additionally, it contains certain information that the Securities and Exchange Commission (the SEC) requires us to provide annually to stockholders. The proxy statement is also the document used by our board to solicit proxies to be used at the 2006 annual meeting. Proxies are solicited to give all stockholders of record an opportunity to vote on the matters to be presented at the annual meeting, even if they cannot attend the meeting. The board has designated Steven J. Shirar and David J. Doedtman as proxies, who will vote the shares represented by proxies at the annual meeting in the manner indicated by the proxies.

What proposals will be voted on at the annual meeting?

Stockholders will vote on the following proposals at the annual meeting:

the election of one Class I director, for a term of three years, in accordance with our amended and restated certificate of incorporation and amended and restated bylaws (Proposal No. 1);

the ratification of the appointment of Ernst & Young LLP as our independent registered public accounting firm (the independent auditors), for the fiscal year ending December 31, 2006 (Proposal No. 2); and

any other business properly coming before the annual meeting and any adjournment or postponement thereof.

Who is entitled to vote?

Each outstanding share entitles its holder to cast one vote on each matter to be voted upon at the annual meeting. Only stockholders of record at the close of business on the record date, March 29, 2006, are entitled to receive notice of the annual meeting and to vote the shares of common stock that they held on that date at the meeting, or any postponement or adjournment of the meeting. If your shares are held in street name, please refer to the information forwarded to you by your bank, broker or other holder of record to see what you must do to vote your shares.

A complete list of stockholders entitled to vote at the annual meeting will be available for examination by any stockholder at our corporate headquarters, 121 South 17th Street, Mattoon, Illinois 61938, during normal business hours for a period of ten days before the annual meeting and at the time and place of the annual meeting.

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What is the difference between a stockholder of record and a beneficial holder of shares?

If your shares are registered directly in your name with our transfer agent, Computershare Trust Company, N.A., you are considered a stockholder of record with respect to those shares. If this is the case, the stockholder proxy materials have been sent or provided directly to you by us.

If your shares are held in a stock brokerage account or by a bank or other nominee, you are considered the beneficial holder of the shares held for you in what is known as street name. If this is the case, the proxy materials have been forwarded to you by your brokerage firm, bank or other nominee, which is considered the stockholder of record with respect to these shares. As the beneficial holder, you have the right to direct your broker, bank or other nominee how to vote your shares. Please contact your broker, bank, or other nominee for instructions on how to vote any shares you beneficially own.

Who can attend the meeting?

All stockholders of record as of March 29, 2006, or their duly appointed proxies, may attend the meeting. Cameras, recording devices and other electronic devices will not be permitted at the meeting. If you hold your shares in street name, you will need to bring a copy of a brokerage statement reflecting your stock ownership as of the record date and check in at the registration desk at the meeting.

What constitutes a quorum?

A quorum of stockholders is necessary to hold the annual meeting. The presence at the meeting, in person or by proxy, of the holders of a majority of the shares of common stock outstanding on the record date will constitute a quorum. As of March 29, 2006, the record date, 29,788,851 shares of our common stock were outstanding. Proxies received but marked as abstentions or broker non-votes will be included in the calculation of the number of shares considered present at the meeting for purposes of establishing a quorum.

How do I vote?

You may vote in person at the meeting or by proxy. We recommend that you vote by proxy even if you plan to attend the meeting so that we will know as soon as possible that enough votes will be present for us to hold the meeting. If you complete and properly sign the accompanying proxy card and return it to us, it will be voted as you direct on the proxy card. If you are a stockholder of record and attend the meeting, you may vote at the meeting or deliver your completed proxy card in person. You should follow the instructions set forth on the proxy card, being sure to complete it, to sign it and to mail it in the enclosed postage-paid envelope.

If your shares are held in street name, please refer to the information forwarded to you by your bank, broker or other holder of record to see what you must do in order to vote your shares. If you are a street name stockholder and you wish to vote in person at the meeting, you will need to obtain a proxy from the institution that holds your shares and present it to the inspector of elections with your ballot when you vote at the annual meeting.

Can I change my vote after I return my proxy card?

Yes. Even after you have submitted your proxy, you may change your vote at any time before the proxy is voted by:

- delivering to our Secretary at the address on the first page of this proxy statement a written notice of revocation of your proxy;
- delivering a duly executed proxy bearing a later date; or
- voting in person at the annual meeting.

If your shares are held in a street name, you may vote in person at the annual meeting if you obtain a proxy as described in the answer to the previous question. The powers of the proxy holders with regard to your

shares will be suspended if you attend the meeting in person and so request, although attendance at the meeting will not, by itself, revoke a previously granted proxy.

Can I vote by telephone or electronically?

No. We have not instituted any mechanism for telephone or electronic voting. Street name stockholders, however, may be able to vote electronically through their bank, broker or other holder of record. If so, instructions regarding electronic voting will be provided by the broker to you as part of the package that includes this proxy statement.

How many votes are required for the proposals to pass?

Directors are elected by a plurality vote. Accordingly, the director nominee with the greatest number of votes cast will be elected. The proposal to ratify the selection of our independent auditors requires the approval of a majority of the votes present, in person or by proxy, and entitled to vote on the matter.

How are abstentions and broker non-votes treated?

If a stockholder abstains from voting on any proposal, it will have the same effect as a vote AGAINST that proposal, except with respect to Proposal No. 1, where it will have no effect. Broker non-votes and shares as to which proxy authority has been withheld with respect to any matter are not entitled to vote for purposes of determining whether stockholder approval for that matter has been obtained and, therefore, will have no effect on the outcome of the vote on any such matter. A broker non-vote occurs on a proposal when shares held of record by a broker are present or represented at the meeting but the broker is not permitted to vote on that proposal without instruction from the beneficial owner of the shares and no instruction has been given.

What if I do not specify a choice for a matter when returning a proxy?

Stockholders should specify their choice for each matter on the enclosed proxy. If no specific instructions are given, proxies that are signed and returned will be voted FOR the election of the nominee for Class I director and FOR the proposal to ratify the appointment of our independent auditors.

Will any one contact me regarding this vote?

No arrangements or contracts have been made or entered into with any solicitors as of the date of this proxy statement, although we reserve the right to engage solicitors if we deem them necessary. If done, such solicitations may be made by mail, telephone, facsimile, e-mail or personal interviews.

What are the board s recommendations?

Unless you give other instructions on your proxy card, the persons named as proxy holders on the enclosed proxy card will vote in accordance with the recommendations of the board of directors.

The board s recommendations, together with the description of each proposal, are set forth in this proxy statement. In summary, the board recommends that you vote:

FOR the election of the nominee for Class I director (see page 6);

FOR the ratification of the appointment of Ernst & Young LLP as our independent auditors (see page 15).

What happens if additional matters are presented at the annual meeting?

Other than the two proposals described in this proxy statement, we are not aware of any other business to be acted upon at the annual meeting. If you grant a proxy, the persons named as proxy holders on the enclosed proxy card will vote your shares on any additional matters properly presented for a vote at the meeting as recommended by the board or, if no recommendation is given, in their own discretion.

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Who will tabulate and certify the vote?

Representatives of Computershare Trust Company, N.A., our transfer agent, will tabulate the votes and act as Inspector of Elections.

ANNUAL REPORT

Will I receive a copy of Consolidated s 2005 Annual Report to Stockholders?

We have enclosed our 2005 annual report to stockholders for the fiscal year ended December 31, 2005 with this proxy statement. The annual report includes our audited financial statements, along with other financial information about us, which we urge you to read carefully.

How can I receive a copy of Consolidated s Annual Report on Form 10-K?

Our annual report on Form 10-K for the fiscal year ended December 31, 2005, as filed with the SEC, is included in the 2005 annual report to stockholders, which accompanies this proxy statement.

You can also obtain, free of charge, a copy of our annual report on Form 10-K by:

accessing the investor relations section of our website at http://ir.consolidated.com and clicking on the SEC Filings link;

writing to:
Consolidated Communications Holdings, Inc. Investor Relations
121 South 17th Street
Mattoon, Illinois 61938; or

telephoning us at: (217) 258-9522.

You can also obtain a copy of our annual report on Form 10-K and other periodic filings that we make with the SEC from the SEC s EDGAR database at http://www.sec.gov.

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STOCK OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information that has been provided to us with respect to the beneficial ownership of shares of our common stock for (i) each stockholder who is known by us to own beneficially more than 5.0% of the outstanding shares of our common stock, (ii) each of our directors, (iii) each of our executive officers named in the Summary Compensation Table on page 18 and (iv) all of our directors and executive officers as a group. Unless otherwise indicated, each stockholder shown on the table has sole voting and investment power with respect to all shares shown as beneficially owned by that stockholder. Unless otherwise indicated this information is current as of March 29, 2006, and the address of all individuals listed in the table is as follows: Consolidated Communications Holdings, Inc., 121 South 17th Street, Mattoon, Illinois 61938-3987.

Name of Beneficial Owner	Aggregate Number of Shares Beneficially Owned	Percentage of Shares Outstanding
Central Illinois Telephone, LLC(a)	5,632,606	18.9%
Providence Equity(b)	3,782,379	12.7%
Jennison Associates LLC(c)	2,332,700	7.8%
Prudential Financial, Inc.(c)	2,332,700	7.8%
FMR Corp.(d)	1,888,900	6.3%
Richard A. Lumpkin(a)	5,632,606	18.9%
Robert J. Currey(e)	371,938	1.2%
Steven J. Shirar(f)	117,940	*
Joseph R. Dively(g)	114,316	*
Steven L. Childers(h)	99,822	*
C. Robert Udell, Jr.(i)	70,692	*
Maribeth S. Rahe(j)	11,433	*
Jack W. Blumenstein(k)	4,000	*
Roger H. Moore(l)	4,000	*
All directors and executive officers as a group (10 persons)	6,489,136	21.8%

* Less than 1.0% ownership.

(a) The equity interests in Central Illinois Telephone, LLC (Central Illinois Telephone) are owned by SKL Investment Group, a Delaware limited liability company. SKL Investment Group is owned by Mr. Lumpkin and members of his family. In addition, Mr. Lumpkin is the sole manager of Central Illinois Telephone. As such, he has the sole investment and voting power with respect to the shares of common stock held by Central Illinois Telephone and, therefore may be deemed to have beneficial ownership of the shares owned by Central Illinois Telephone. He disclaims this beneficial ownership except to the extent of his pecuniary interest in those securities. The address of Central Illinois Telephone and Mr. Lumpkin is P.O. Box 1234, Mattoon, Illinois 61938

(b) Consists of 3,770,219 shares of common stock held by Providence Equity Partners IV L.P. and 12,160 shares of common stock held by Providence Equity Operating Partners IV L.P. The address of Providence Equity Partners IV L.P. and Providence Equity Operating Partners IV L.P. is c/o Providence Equity Partners, Inc., 50 Kennedy Plaza, 18th Floor, Providence, Rhode Island 02903.

(c) Beneficial and percentage ownership information is based on information contained in a Schedule 13G filed with the SEC on February 9, 2006 by Prudential Financial, Inc. and in a Schedule 13G filed with the SEC on February 14, 2006 by Jennison Associates LLC. The schedule contains the following information regarding

beneficial ownership of the shares: Prudential Financial, Inc., as the parent holding company and the direct or indirect parent of Jennison Associates LLC, may be deemed the beneficial owner of securities beneficially owned by Jennison Associates LLC and may have direct or indirect voting and/or investment discretion over 2,332,700 shares that are held for its own benefit or for the benefit of

its clients by its separate accounts, externally managed accounts, registered investment companies, subsidiaries and/or other affiliates. The address of Jennison Associates LLC is 466 Lexington Avenue, New York, New York 10017. The address of Prudential Financial, Inc. is 751 Broad Street, Newark, New Jersey 07102-3777.

(d) Beneficial and percentage ownership information is based on information contained in a Schedule 13G filed with the SEC on February 14, 2006 by FMR Corp. on behalf of itself and affiliated persons and entities. The schedule contains the following information: Fidelity Management & Research Company (a wholly owned subsidiary of FMR Corp.) is the beneficial owner of the shares by virtue of acting as investment advisor to various investment companies. Edward C. Johnson III, FMR Corp. and the Fidelity Funds each has sole power to dispose of these shares. Neither Edward C. Johnson III nor FMR Corp. has the sole power to vote or direct the voting of the shares owned by the Fidelity Funds; such shares are voted by the Board of Trustees for the Fidelity Funds. The address of FMR Corp. is 82 Devonshire Street, Boston, Massachusetts 02109.

(e) Consists of 299,466 shares of common stock initially awarded under our restricted share plan and 72,472 shares owned by Mr. Currey through an IRA trust.

(f) Consists of 99,822 shares of common stock initially awarded under our restricted share plan and 18,118 shares owned by Mr. Shirar through a trust.

(g) Includes 99,822 shares of common stock initially awarded under our restricted share plan and 14,494 shares owned by Mr. Dively.

(h) Consists of shares initially awarded under our restricted share plan.

(i) Includes 19,965 shares of common stock initially awarded under our restricted share plan and 30,000 shares initially awarded under our long-term incentive plan.

(j) Includes 4,000 shares of common stock initially awarded under our long-term incentive plan.

(k) Consists of shares of common stock initially awarded under our long-term incentive plan.

(l) Consists of shares of common stock initially awarded under our long-term incentive plan.

PROPOSAL NO. 1 ELECTION OF DIRECTOR

Our amended and restated certificate of incorporation provides for the classification of our board of directors into three classes of directors, designated Class I, Class II and Class III, as nearly equal in size as is practicable, serving staggered three-year terms. One class of directors is elected each year to hold office for a three-year term or until successors of such directors are duly elected and qualified. The term of the current Class I director, Richard A. Lumpkin, expires upon the election and qualification of the Class I director to be elected at the annual meeting. The terms of Messrs. Blumenstein and Moore as Class II directors do not expire until the 2007 annual meeting, and the terms of Mr. Currey and Ms. Rahe as Class III directors do not expire until the 2008 annual meeting. The corporate governance committee has recommended, and the board also recommends, that the stockholders elect Richard A. Lumpkin, the nominee designated below as the Class I director, at this year s annual meeting to serve for a term of three years expiring in 2009 or until his successor is duly elected and qualified. The nominee for election to the office of Class I director, and certain information with respect to his background and the backgrounds of non-nominee directors, are set forth below.

It is the intention of the persons named in the accompanying proxy card, unless otherwise instructed, to vote to elect the nominee named herein as the Class I director. The nominee named herein presently serves as our chairman of the board of directors. In the event the nominee named herein is unable to serve as a director, discretionary authority is reserved to the board to vote for a substitute. The board has no reason to believe that the nominee named herein will

be unable to serve if elected.

Nominee standing for election to the board

Name	Age	Current Position With Consolidated
Richard A. Lumpkin (Class I Director)	71	Chairman

Non-nominees continuing to serve in the office of director

Name	Age	Current Position With Consolidated
Robert J. Currey (Class III Director)	60	President, Chief Executive Officer and Director
Jack W. Blumenstein (Class II Director)	62	Director
Roger H. Moore (Class II Director)	64	Director
Maribeth S. Rahe (Class III Director)	57	Director

Business experience of nominee to the board

Richard A. Lumpkin has served as our Chairman of the board since 2002. From 1997 to 2002, Mr. Lumpkin served as Vice Chairman of McLeodUSA, which acquired the predecessor of Consolidated Communications, Inc. (CCI) in 1997. From 1963 to 1997, Mr. Lumpkin served in various positions at the predecessor of CCI and Illinois Consolidated Telephone Company (ICTC), including Chairman, Chief Executive Officer, President and Treasurer. Mr. Lumpkin is currently a director of Ameren Corp., a public utility holding company, First Mid-Illinois Bancshares, Inc., or First Mid-Illinois, a financial services holding company, and Agracel, Inc., a real estate investment company, and serves on the advisory board of Eastern Illinois University and as a trustee of The Lumpkin Family Foundation. Mr. Lumpkin is also a former director, former President and former Treasurer of the United States Telecom Association and a former president of the Illinois Telecommunications Association. Mr. Lumpkin has also served on the University Council Committee on Information Technology for Yale University.

Business experience of continuing directors

Robert J. Currey serves as our President, Chief Executive Officer and a director. Mr. Currey has served as our director since 2002 and as President and Chief Executive Officer of CCI since 2002. From 2000 to 2002, Mr. Currey served as Vice Chairman of RCN Corporation, a competitive telephone company providing telephony, cable and Internet services in high-density markets nationwide. From 1998 to 2000, Mr. Currey served as President and Chief Executive Officer of 21st Century Telecom Group. From 1997 to 1998, Mr. Currey served as Director and Group President of Telecommunications Services of McLeodUSA, which acquired the predecessor of CCI in 1997. Mr. Currey joined the predecessor of CCI in 1990 and served as President through its acquisition in 1997. Mr. Currey is also a director of Management Network Group, Inc., the United States Telecom Association and the Illinois Business RoundTable and is also a former director of Telution Inc.

Jack W. Blumenstein has served as our director since our initial public offering in July 2005. Mr. Blumenstein is Chairman and Chief Executive Officer of AirCell, Inc., a provider of airborne cellular and satellite telecommunications systems and services. He has been the co-President of Blumenstein/ Thorne Information Partners, LLC since October 1996, and is a co-founder of that private equity investment firm. Blumenstein/ Thorne focuses on capital transactions in the telecommunications and information industry. From October 1992 to September 1996, Mr. Blumenstein held various positions with The Chicago Corporation (now ABN AMRO, Inc.), serving most recently as Executive Vice President, Debt Capital Markets Group and a member of the Board of Directors. Mr. Blumenstein was President and Chief Executive Officer of ARDIS Company, a joint venture of Motorola and

IBM, and has held various senior management

positions in product development and sales and marketing for Rolm Corporation and IBM. Mr. Blumenstein also presently serves on the boards of eCollege.com, AirCell, Inc., and ShopperTrak, Inc.

Roger H. Moore has served as our director since our initial public offering in July 2005. Mr. Moore was President and Chief Executive Officer of Illuminet Holdings, Inc., a provider of network, database and billing services to the communications industry, since October 1998, a member of its board of directors since July 1998, and was its President and Chief Executive Officer from January 1996 to August 1998. In December of 2001, Illuminet was acquired by VeriSign, Inc. and Mr. Moore retired at that time. From September 1998 to October 1998, he served as President, Chief Executive Officer and a member of the board of directors of VINA Technologies, Inc., a telecommunications equipment company. Mr. Moore also presently serves as a director of Arbinet-thexchange, Inc., Tut Systems, Inc., VeriSign, Inc. and Western Digital Corporation.

Maribeth S. Rahe has served as our director since our initial public offering in July 2005. Ms. Rahe has served as President and Chief Executive Officer of Fort Washington Investment Advisors, Inc. since November 2003. From January 2001 to October 2002, Ms. Rahe was President and a member of the board of directors of U.S. Trust Company of New York and, from June 1997 to January 2001, was its Vice Chairman and a member of the board of directors.

Board recommendation and stockholder vote required

The board of directors recommends a vote FOR the election of the nominee named above (Proposal No. 1 on the accompanying proxy card).

The affirmative vote of a plurality of the votes cast at the meeting at which a quorum is present is required for the election of the nominee.

CORPORATE GOVERNANCE AND BOARD COMMITTEES

Are a majority of the directors independent?

Yes. The corporate governance committee undertook its annual review of director independence and reviewed its findings with the board of directors. During this review, the board of directors considered relationships and transactions between each director or any member of his or her immediate family and Consolidated and its subsidiaries and affiliates, including those reported under Related Party Transactions below. The board of directors also examined relationships and transactions between directors or their affiliates and members of our senior management. The purpose of this review was to determine whether any such transactions or relationships compromised a director s independence.

As a result of this review, our board of directors affirmatively determined that Messrs. Blumenstein and Moore and Ms. Rahe are independent for purposes of both Rule 4200(a)(15) of The NASDAQ Stock Market, Inc. s (NASDAQ) Marketplace Rules and Rule 10A-3(b)(1) of the Exchange Act.

How are directors compensated?

We pay our non-employee directors an annual cash retainer of $12,500. Board members also are paid $1,000 for each board meeting attended in person, $500 for each board committee meeting attended in person. Meeting fees are halved for each board or board committee meeting attended by means of telephone conference call. We reimburse all non-employee directors for reasonable expenses incurred to attend board or board committee meetings.

In addition, the chairperson of the audit committee receives an additional annual cash retainer of $15,000, and the chairperson of the compensation committee and the corporate governance committee each receive an additional annual retainer of $5,000.

Each non-employee director is eligible to receive grants of stock options, stock grants and stock unit grants, stock appreciation rights and cash bonuses pursuant to one or more cash incentive programs that may be adopted under our 2005 long-term incentive plan, subject to certain limitations on the number and amount

of such grants contained in the plan. No grants were made to our non-employee directors under this plan during 2005.

Directors who also serve as executive officers receive compensation solely for acting in such capacity as an executive officer; no additional fees are paid to them for their service to the board.

How often did the board meet during 2005?

The board met twice during the period beginning with the consummation of our initial public offering on July 27, 2005 through the end of 2005. Each director attended all of the meetings of the board. During 2005, the non-employee directors also met twice in executive session.

What is the policy regarding director attendance at annual meetings?

Absent special circumstances, each director is expected to attend the annual meeting of stockholders.

What committees has the board established?

The board has standing audit, corporate governance and compensation committees. As of December 31, 2005, the membership of the standing committees was as follows:

Name	Audit Committee	Governance Committee	Compensation Committee
Jack W. Blumenstein	Chairperson		*
Roger H. Moore	*	*	Chairperson
Maribeth S. Rahe	*	Chairperson	
Richard A. Lumpkin		*	*

* indicates member

Audit Committee. The audit committee consists of Messrs. Blumenstein and Moore and Ms. Rahe. The board has determined that all members of the audit committee are independent for purposes of Rule 4200(a)(15) of NASDAQ s Marketplace Rules and Rule 10A-3(b)(1) of the Exchange Act. Each of the audit committee members is financially literate as determined by our board in its business judgment. The board has also determined that in addition to being independent, each of Mr. Blumenstein, Mr. Moore and Ms. Rahe is an audit committee financial expert as such term is defined under the applicable SEC rules.

The audit committee was established in connection with our initial public offering in July 2005, and met three times during 2005. The board has adopted an audit committee charter, which is attached as Appendix A hereto and may also be found by accessing the investor relations section of our website at *http://ir.www.consolidated.com* and clicking on the Corporate Governance link.

The principal duties and responsibilities of the audit committee are to assist the board in its oversight of:

- the integrity of our financial statements and reporting process;
- our compliance with legal and regulatory matters;
- the independent auditor s qualifications and independence; and
- the performance of our independent auditors.

Our audit committee is also responsible for the following:

- conducting an annual performance evaluation of the audit committee;
- compensating, retaining, and overseeing the work of our independent auditors;

establishing procedures for (a) receipt and treatment of complaints on accounting and other related matters and (b) submission of confidential employee concerns regarding questionable accounting or auditing matters;

approving all related party transactions required to be disclosed in our proxy statement pursuant; and

preparing reports to be included in our public filings with the SEC.

The audit committee has the power to investigate any matter brought to its attention within the scope of its duties. It also has the authority to retain counsel and advisors to fulfill its responsibilities and duties. See the Report of the Audit Committee of the Board of Directors on page 13.

Corporate Governance Committee. The corporate governance committee consists of Messrs. Lumpkin and Moore and Ms. Rahe, who serves as the Chairperson. The board has determined that each of Ms. Rahe and Mr. Moore are independent for purposes of Rule 4200(a) (15) of NASDAQ s Marketplace Rules. As required by applicable NASDAQ rules, we intend for the corporate governance committee to be fully independent within one year of our initial public offering. The corporate governance committee was established in connection with our initial public offering in July 2005 and did not meet between July 27, 2005 and December 31, 2005. The board has adopted a corporate governance committee charter, a copy of which may be found by accessing the investor relations section of our website at *http://ir.www.consolidated.com* and clicking on the Corporate Governance link.

The principal duties and responsibilities of the corporate governance committee are as follows:

to identify individuals qualified to become directors and to select, or recommend that the board select director nominees;

to develop and recommend to the board the content of our corporate governance principles, a copy of which may be found by accessing the investor relations section of our website at *http://ir.www.consolidated.com* and clicking on the Corporate Governance link; and.

to oversee the evaluation of our board and management team.

In evaluating candidates for directorships, our board, with the assistance of the corporate governance committee, will take into account a variety of factors it considers appropriate, which may include strength of character and leadership skills; general business acumen and experience; broad knowledge of the telecommunications industry; knowledge of strategy, finance, internal business and relations between telecommunications companies and government; age; number of other board seats; and willingness to commit the necessary time to ensure an active board whose members work well together and possess the collective knowledge and expertise required by the board. We have not previously paid a fee to any third party in consideration for assistance in identifying potential nominees for the board.

Compensation Committee. The compensation committee consists of Messrs. Blumenstein, Lumpkin, and Moore, who serves as its Chairperson. The board has determined that each of Mr. Blumenstein and Mr. Moore are independent for purposes of Rule 4200(a)(15) of NASDAQ s Marketplace Rules. As required by applicable NASDAQ rules, we intend for the compensation committee to be fully independent within one year of our initial public offering. The compensation committee was established in connection with our initial public offering in July 2005 and did not meet between July 27, 2005 and December 31, 2005. The board has adopted a compensation committee charter, a copy of which may also be found by accessing the investor relations section of our website at *http://ir.www.consolidated.com* and clicking on the Corporate Governance link.

The principal duties and responsibilities of the compensation committee are as follows:

to review and approve goals and objectives relating to the compensation of our Chief Executive Officer and, based upon a performance evaluation, to determine and approve the compensation of the Chief Executive Officer;

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to make recommendations to our board of directors on the compensation of other executive officers and on incentive compensation and equity-based plans; and

to prepare reports on executive compensation to be included in our public filings with the SEC.

Stockholder Recommendations for Director Nominations

As noted above, the corporate governance committee considers and establishes procedures regarding recommendations for nomination to the board, including nominations submitted by stockholders. Recommendations of stockholders should be timely sent to us, either in person or by certified mail, to the attention of the Secretary. Any recommendations submitted to the Secretary should be in writing and should include whatever supporting material the stockholder considers appropriate in support of that recommendation, but must include the information that would be required to be disclosed under the SEC s rules in a proxy statement soliciting proxies for the election of such candidate and a signed consent of the candidate to serve as our director if elected. The corporate governance committee will evaluate all potential candidates in the same manner, regardless of the source of the recommendation. Based on the information provided to the corporate governance committee, it will make an initial determination whether to conduct a full evaluation of a candidate. As part of the full evaluation process, the corporate governance committee may conduct interviews, obtain additional background information and conduct reference checks of the candidate, among other things. The corporate governance committee may also ask the candidate to meet with management and other members of the board.

Communications with Directors

Kelly D. Conway has been the President and Chief Executive Officer and a Director of eLoyalty, which was spun out of Technology Solutions Company (TSC) in 2000 since its incorporation in May 1999. Mr. Conway had joined TSC in November 1993 as Senior Vice President, assumed the position of Executive Vice President in July 1995 and became Group President in October 1998. Prior to joining TSC, Mr. Conway served as a Partner in the management consulting firm of Spencer, Shenk and Capers and held various positions, including President and Chief Executive Officer with Telcom Technologies, a manufacturer of automatic call distribution equipment.

Christopher B. Min has been Vice President and Chief Financial Officer of eLoyalty since December 2007. Prior to joining eLoyalty, Mr. Min held several finance positions at First Data Corporation, including divisional CFO roles from July 2000 until November 2007.

Steven C. Pollema has been Vice President, Integrated Contact Solutions and CRM Business Unit since December 2007. Previously, he served as Vice President, Operations and Chief Financial Officer of eLoyalty since December 2004. Prior to that Mr. Pollema served as Vice President, Delivery and Operations of eLoyalty since August 2001, after joining eLoyalty in June 2001 as Senior Vice President, Operations. Prior to joining eLoyalty, Mr. Pollema had been with MarchFirst, Inc. and its predecessor, Whittman-Hart, Inc., since June 1997, most recently as its President from March 2001 to May 2001. Prior to assuming the office of President, Mr. Pollema was Executive Vice President-Global Operations of MarchFirst from October 2000 through March 2001 and Managing Executive Chicago Office/Region from October 1998 to October 2000.

Steven H. Shapiro has been Vice President, General Counsel and Corporate Secretary of eLoyalty since April 2006. Prior to joining eLoyalty, Mr. Shapiro served as Executive Vice President and Corporate Secretary of First Midwest Bancorp, Inc. from January 2003 until April 2006.

PART II.

Item 5. ***Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.***

Our common stock, par value $0.01 per share, is traded on the NASDAQ Global Market under the symbol ELOY. The following table sets forth, for the periods indicated, the quarterly high and low sales prices of the common stock on the NASDAQ Global Market.

	High	Low
Fiscal Year 2007		
Fourth Quarter	$ 16.33	$ 9.60
Third Quarter	22.68	11.81

Second Quarter	25.84	18.99
First Quarter	23.49	17.95
Fiscal Year 2006		
Fourth Quarter	$ 19.80	$ 17.20
Third Quarter	19.36	11.66
Second Quarter	18.25	12.44
First Quarter	16.50	9.63

There were approximately 162 owners of record of our common stock as of March 3, 2008.

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Stock Performance Graph

The following graph compares the cumulative total stockholder return on eLoyalty Common Stock with the cumulative total return of (i) the NASDAQ Global Market Index, and (ii) a peer group of other publicly traded information technology consulting companies selected by the Company (the Peer Group Index). Cumulative total stockholder return is based on the period from December 27, 2002 through the Company s fiscal year end on Saturday, December 29, 2007. The comparison assumes that $100 was invested on December 27, 2002 in each of eLoyalty Common Stock, the NASDAQ Global Market Index and the Peer Group Index, and that any and all dividends were reinvested.

Comparative Cumulative Total Return

For eLoyalty Corporation,

NASDAQ Global Market Index and Peer Group Index

	12/27/02	12/26/03	12/31/04	12/30/05	12/29/06	12/29/07
eLoyalty Corporation	$ 100.00	$ 99.73	$ 156.38	$ 273.67	$ 498.67	$ 334.57
Peer Group Index[(1)]	100.00	254.00	348.97	247.16	256.43	338.74
NASDAQ Global Market Index	100.00	150.36	163.00	166.58	183.68	201.91

(1) The Peer Group Index consists of The Hackett Group previously (AnswerThink Inc.), Diamond Management & Technology Consultants and Sapient Corporation. Inforte Corporation was removed from the peer group because its information is no longer publicly available.

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Repurchase of Equity Securities

The following table provides information relating to the Company s purchase of shares of its common stock in the fourth quarter of 2007. All of these purchases reflect shares withheld upon vesting of restricted stock or installment stock, to satisfy tax-withholding obligations.

Period	Total Number of Shares Purchased	Average Price Paid Per Share
September 30, 2007 October 29, 2007		
Common stock		
October 30, 2007 November 29, 2007		
Common stock	14,965	$ 14.97
November 30, 2007 December 29, 2007		
Common stock	26,292	$ 13.07
Total	41,257	$ 13.76

See Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters included in Part II Item 12 of this Form 10-K for more information about securities authorized for issuance under our various compensation plans.

Dividends

Historically, we have not paid cash dividends on our common stock, and do not expect to do so in the future. However, cash dividends of $1.5 million were paid in 2007 on the Company s Series B convertible preferred stock (the Series B stock), which accrues dividends at the rate of 7% per year, payable semi-annually in January and July. A dividend payment of $0.7 million was paid in January 2008 on the Series B stock. In addition, a semi-annual dividend payment of approximately $0.6 million is expected to be paid in future periods on the Series B stock. The amount of each such dividend would decrease by any conversions of the Series B stock into common stock, although such conversions would require us to pay accrued but unpaid dividends at time of conversion. Conversions of Series B stock became permissible at the option of the holder after June 19, 2002. See further discussion under Part I Item 7, Liquidity and Capital Resources discussion.

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Item 6. ***Selected Financial Data.***

The following tables summarize our selected financial data. This information should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations, and the Consolidated Financial Statements of the Company and notes thereto, which are included elsewhere in this Form 10-K. The statements of operations data for the fiscal years ended 2007, 2006, 2005, 2004 and 2003 and the balance sheet data as of December 29, 2007, December 30, 2006, December 31, 2005, January 1, 2005 and December 27, 2003, below, are derived from our audited financial statements. Fiscal year 2004 consisted of fifty-three weeks instead of fifty-two weeks, which did not have a material impact on our financial position or results of operations.

	Consolidated Statements of Operations Data (In thousands, except share and per share data)				
	For the Fiscal Years Ended				
	2007	2006	2005	2004	2003
Revenue:					
Services	$ 88,046	$ 71,980	$ 65,556	$ 65,090	$ 56,579
Product	9,185	13,579	9,710	3,153	2,198
Revenue before reimbursed expenses (net revenue)	97,231	85,559	75,266	68,243	58,777
Reimbursed expenses	4,874	4,269	3,742	4,330	3,802
Total revenue	102,105	89,828	79,008	72,573	62,579
Operating Expenses:					
Cost of services[(1)(2)]	58,496	58,604	49,477	46,468	43,087
Cost of product	6,993	10,183	7,331	2,434	1,778
Cost of revenue before reimbursed expenses	65,489	68,787	56,808	48,902	44,865
Reimbursed expenses	4,874	4,269	3,742	4,330	3,802
Total cost of revenue, exclusive of depreciation and amortization shown below:	70,363	73,056	60,550	53,232	48,667
Selling, general and administrative[(1)(2)]	47,075	25,328	20,385	19,482	23,727
Severance and related costs[(1)]	1,333	737	411	947	2,405
Depreciation	3,186	2,095	5,151	5,247	5,299
Amortization of intangibles	423	370	532	350	63
Goodwill impairment[(3)]					557
Total operating expenses	122,380	101,586	87,029	79,258	80,718
Operating loss	(20,275)	(11,758)	(8,021)	(6,685)	(18,139)
Interest and other income (expense), net	1,484	681	374	231	256
Loss before income taxes	(18,791)	(11,077)	(7,647)	(6,454)	(17,883)
Income tax benefit (provision)	53	(71)	17	587	(388)
Net loss	(18,738)	(11,148)	(7,630)	(5,867)	(18,271)
Dividends related to Series B preferred stock	(1,405)	(1,464)	(1,471)	(1,499)	(1,508)
Net loss available to common stockholders	$ (20,143)	$ (12,612)	$ (9,101)	$ (7,366)	$ (19,779)
Basic net loss per common share	$ (2.40)	$ (1.86)	$ (1.43)	$ (1.22)	$ (3.48)

Diluted net loss per common share	$ (2.40)	$ (1.86)	$ (1.43)	$ (1.22)	$ (3.48)
(In millions)					
Basic weighted average shares outstanding	8.40	6.77	6.36	6.03	5.69
Diluted weighted average shares outstanding	12.90	11.70	10.90	10.44	9.86

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[(1)] Stock-based compensation, primarily restricted stock, included in individual line items above:

	(In Thousands) For the Fiscal Year Ended				
	2007	2006	2005	2004	2003
Cost of services	$ 1,004	$ 1,632	$ 1,154	$ 1,063	$ 834
Selling, general and administrative	9,444	2,386	1,462	1,697	2,101
Severance and related costs	196		(25)	176	

[(2)] Beginning in fiscal year 2007, the Company classified $18.3 million of certain expenses, which had been previously reported within Cost of services as Selling, general and administrative expense. For further discussion see Part II Item 7 of this Form 10-K, Year Ended December 29, 2007 Compared with the Year Ended December 30, 2006 .

[(3)] The Company tests goodwill for impairment annually. For the year ended December 27, 2003, the analysis indicated that goodwill associated with our International reporting unit was fully impaired and an adjustment of $0.6 million was recorded in the Consolidated Statement of Operations.

Consolidated Balance Sheet Data

(In thousands)

			As of		
	December 29, 2007	December 30, 2006	December 31, 2005	January 1, 2005	December 27, 2003
Total cash[(1)]	$ 23,867	$ 31,928	$ 18,375	$ 20,793	$ 28,002
Short-term investments[(2)]	$ 451	$	$ 4,000	$ 6,975	$ 9,850
Working capital[(3)]	$ 20,621	$ 32,640	$ 25,341	$ 28,565	$ 33,869
Total assets	$ 60,051	$ 64,568	$ 45,228	$ 55,367	$ 59,805
Long-term obligations	$ 9,041	$ 5,471	$ 1,145	$ 1,438	$ 1,144
Redeemable preferred stock	$ 19,100	$ 20,902	$ 20,910	$ 21,169	$ 21,197
Stockholders equity	$ 7,803	$ 18,614	$ 11,475	$ 18,963	$ 24,018

[(1)] Total cash consists of cash and cash equivalents of $21.4 million, $31.6 million, $17.9 million, $20.1 million and $27.1 million and restricted cash of $2.5 million, $0.3 million, $0.5 million, $0.7 million and $0.9 million as of December 29, 2007, December 30, 2006, December 31, 2005, January 1, 2005 and December 27, 2003, respectively.

[(2)] Prior to 2006, short-term investments reflected above were auction rate securities. In 2007, included in other current assets is $0.5 million of investments which represent the market value of equity securities in an unrelated publicly traded company.

[(3)] Represents total current assets less total current liabilities.

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations.***

Critical Accounting Policies and Estimates

Our management s discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to the costs and timing of

completion of client projects, our ability to collect accounts receivable, the timing and amounts of expected payments associated with cost reduction activities, the ability to realize our net deferred tax assets, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

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

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Revenue Recognition

Behavioral Analytics Service Line

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

Managed services revenue included in the Behavioral Analytics Service Line consists of planning, deployment, training, and subscription fees. The planning, deployment and training fees, which are considered to be installation fees, related to the long-term subscription contract are deferred until the installation is complete and are then recognized over the term of the applicable subscription contract. The terms of these subscription contracts generally range from three to five years. As of December 29, 2007 and December 30, 2006, deferred revenue totaled $5.4 million and $5.5 million, respectively. Installation costs incurred are deferred up to an amount not to exceed the amount of deferred installation revenue and additional amounts that are recoverable based on the contractual arrangement. Such costs are amortized over the term of the subscription contract. Costs in excess of the foregoing revenue amount are expensed in the period incurred. As of December 29, 2007 and December 30, 2006, the Company had deferred costs totaling $3.5 million and $3.7 million, respectively.

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

Integrated Contact Solutions Service Line

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

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

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

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

Within the Integrated Contact Solutions Service Line, Consulting services, Managed services and the resale of Product may be sold and delivered together. In arrangements that include the resale of software, SOP 97-2 requires determination of vendor specific objective evidence (VSOE) for each of the individual

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elements. If VSOE does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement is deferred until all elements of the arrangement without VSOE have been delivered to the client. If the remaining undelivered elements are post contract support (PCS) or other deliverables with similar attribution periods, the arrangement revenue is recognized ratably over the remaining service period. Revenue of $1.5 million and $2.1 million has been deferred as of December 29, 2007 and December 30, 2006, respectively, due to the lack of VSOE for elements within these arrangements. This revenue will be recognized when the elements without VSOE are delivered to the client or will be recognized ratably over the remaining service period.

Traditional CRM

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

Managed services revenue included in the traditional CRM Service Line consists of marketing application hosting, email fulfillment and remote application support. Revenue related to hosting services is generally a fixed monthly fee and is recognized as the services are performed for the client. Any related setup fee would be recognized over the contract period of the hosting arrangement. Revenue related to email fulfillment services is recognized as the services are provided to the client based on the number of emails distributed for the client. Contracts for remote application support can be based on a fixed fee or time and materials basis. Revenue is recognized ratably over contract period for fixed fee support. Revenue is recognized as the services are provided to the client for time and material contracts.

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

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

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

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

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

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Stock-Based Compensation

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

Prior to January 1, 2006, we used the intrinsic value method to account for stock-based employee compensation under Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees, and therefore we did not recognize compensation expense in association with options granted at or above the market price of our common stock at the date of grant (see Note Fifteen Stock-Based Compensation).

Severance and Related Costs

We recorded accruals for severance and related costs associated with our cost reduction efforts undertaken during fiscal years 2001 through 2007. The portion of the accruals relating to employee severance represents contractual severance for identified employees and generally is not subject to a significant revision. In prior years, a portion of the accruals related to office space reductions, office closures and associated contractual lease obligations that were based in part on assumptions and estimates of the timing and amount of sublease rentals affected by overall economic and local market conditions. To the extent estimates of the success of our sublease efforts changed, adjustments increasing or decreasing the related accruals have been recognized.

Income Taxes

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109, Accounting for Income Taxes. The Company adopted the provisions of FIN 48 on December 31, 2006. The Interpretation addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. Significant judgment is used to determine the likelihood of the benefit. FIN 48 also provides guidance on derecognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures.

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

Other Significant Accounting Policies

For a description of the Company s other significant accounting policies, see Note Two Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements included in Part II Item 8 of this Form 10-K.

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Forward-Looking Statements

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

- Uncertainties associated with the attraction of new clients, the continuation of existing and new engagements with existing clients and the timing of related client commitments; reliance on a relatively small number of clients for a significant percentage of our revenue;
- Risks involving the variability and predictability of the number, size, scope, cost, and duration of and revenue, and client engagements;
- Variances in sales of products in connection with client engagements;
- Management of the other risks associated with increasingly complex client projects and new service offerings, including execution risk;
- Management of growth and development and introduction of new service offerings, including Behavioral Analytics;
- Challenges in attracting, training, motivating and retaining highly skilled management, strategic, technical, product development and other professional employees in a competitive information technology labor market;
- Risks associated with our reliance on Cisco Systems, Inc., a large primary product partner within our Integrated Contact Solutions Service Line, including our reliance on their product positioning, pricing, and discounting strategies;
- Reliance on major suppliers, including CRM software providers and other alliance partners, and maintenance of good relations with key business partners;
- Continuing intense competition in the information technology services industry generally and, in particular, among those focusing on the provision of CRM services and software;
- The rapid pace of technological innovation in the information technology services industry;
- Protection of our technology, proprietary information and other intellectual property rights from challenges by third parties;
- The ability to raise sufficient amounts of debt or equity capital to meet our future operating and financial needs;

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

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

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

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

General economic, business and market conditions;

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

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

Background

For background information, see discussion under Overview included in Part I Item 1 of this Form 10-K.

Business Outlook

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

In fiscal year 2008, we anticipate moderate growth in overall Services revenue as a result of continued progress in our primary Service Lines. The moderate growth anticipated in these lines of business should be partially offset by the decline in our Traditional CRM Service Line. We expect moderate revenue growth in Managed services revenue as a result of higher Integrated Contact Solutions support and maintenance revenue and substantially higher Behavioral Analytics deployment and subscription revenue. Other sources of Managed services revenue, such as remote application maintenance and support and Marketing Managed Services, are likely to decline slightly in 2008. A decrease in Consulting services revenue is likely as the anticipated decline in CRM Consulting will only be partially offset by modest and substantial growth in Consulting revenue from our Integrated Contact Solutions and Behavioral Analytics Service Lines, respectively.

Product revenue is expected to increase slightly in 2008. Product revenue levels, however, may fluctuate significantly in each fiscal quarter because the Company is not always selected as the product supplier for the engagement.

We continue to invest in the personnel required to sell and manage complex, long-term relationships and in the resources required to develop, deliver and support our innovative Behavioral Analytics solution. These investments will continue to put pressure on our profitability and cash resources in 2008, but we believe they are required to continue to build our Managed services backlog and to maintain and strengthen our competitive advantage. In light of this pressure, management has and will continue to assess all areas of the cost structure to identify opportunities to maximize profitability and cash resources. For example, the Salary Replacement Program was extended beyond the initial period and expanded to include additional employees.

Managed Services Backlog

As a result of the strategic and long-term nature of Managed services revenue, we believe it is appropriate to monitor the level of backlog associated with these agreements. The Managed services backlog was $72.8 million as of December 29, 2007 and $60.7 million as of December 30, 2006. Of the December 29, 2007 backlog, 63% is related to Behavioral Analytics, 27% is related to our Integrated Contact Solutions offerings and the remaining balance is from other Managed services.

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

Year Ended December 29, 2007 Compared with the Year Ended December 30, 2006

Revenue

	For the Fiscal Years Ended			
	2007		2006	
	Dollars in Millions	% of Net Revenue	Dollars in Millions	% of Net Revenue
Revenue:				
Consulting services	$ 49.4	51%	$ 44.3	52%
Managed services	38.6	40%	27.7	32%
Services revenue	**88.0**	**91%**	**72.0**	**84%**
Product	9.2	9%	13.6	16%
Net revenue	**97.2**	**100%**	**85.6**	**100%**
Reimbursed expenses	4.9		4.2	
Total revenue	**$ 102.1**		**$ 89.8**	

Net revenue is total revenue excluding reimbursable expenses that are billed to our clients. Our net revenue increased 14% to $97.2 million in fiscal year 2007, an increase of $11.6 million, from $85.6 million in fiscal year 2006.

Revenue from Consulting services increased by $5.1 million to $49.4 million in fiscal year 2007 from $44.3 million in fiscal year 2006, an increase of 12%. Consulting services represented 51% and 52% of net revenue for fiscal years 2007 and 2006, respectively. The increase in Consulting services revenue is primarily due to 30% growth of our Integrated Contact Solutions Service Line driven by our continued focus on the service line, a general movement toward voice over IP solutions in the call center market space and the strengthening of our relationship with Cisco, one of the largest providers of the technology that enables voice over IP solutions. Also, our Behavioral Analytics Service Line grew 151% in 2007, driven by a continuously increasing focus on the service line that resulted in a significant increase in the number of assessments in 2007 compared to 2006. The growth in our two primary service lines was partially offset by slower growth in our Traditional CRM consulting revenue as we continue to shift our focus to our two primary service lines. Spending by our Consulting services clients may fluctuate between periods in all service lines due to the short-term nature of these agreements.

Utilization of billable consulting personnel was 76% for fiscal year 2007, compared to 73% for fiscal year 2006. Utilization is defined as billed time as a percentage of total available time. The average bill rate remained constant at $151 for the 2007 and 2006 fiscal years.

Revenue from Managed services was $38.6 million in fiscal year 2007, an increase of $10.9 million, or 39%, from $27.7 million in fiscal year 2006. Managed services represented 40% of net revenue for fiscal year 2007, compared to 32% of net revenue for fiscal year 2006. The increase in revenue from Managed services resulted from the transition of several Behavioral Analytics projects from the assessment to the subscription phase in late 2006 and in 2007 and from the continued growth of support and maintenance revenue from existing

clients in our Integrated Contact Solutions Service Line. As we continue to transition clients from the assessment phase to the deployment phase in our Behavioral Analytics service line and as we continue to provide maintenance and support services to a growing base of clients that we have installed voice over IP systems for, we expect Managed services revenue to continue to grow as a percentage of our net revenue.

Revenue from the sale of Product decreased by 32%, or $4.4 million, to $9.2 million in fiscal year 2007 from $13.6 million in fiscal year 2006. Revenue from the sale of Product represented 9% of net revenue for fiscal year 2007 compared to 16% of net revenue for fiscal year 2006. There are significant variances in size among individual engagements within this Service Line, and the Company is not always selected as the Product supplier for the engagement. We resale products to our clients to provide a complete solution when requested, but we do not focus our sales effort on driving Product revenue. As a result, annual and quarterly Product revenue may fluctuate significantly.

Management no longer views revenue from international operations as a separate segment. Although the Company does support and will continue to support its international customer base, management is not actively seeking new international business, does not manage international operations separately, and is in the process of closing international subsidiaries and remote offices that are no longer in use.

The Company s top 5 clients accounted for 41% of total revenue in fiscal year 2007, compared to 42% in fiscal year 2006. The top 10 clients accounted for 54% of total revenue in fiscal year 2007, compared to 62% in fiscal year 2006. The top 20 clients accounted for 73% of total revenue in fiscal year 2007, compared to 79% of total revenue in fiscal year 2006. One customer, United HealthCare Services, Inc., accounted for 24% of total revenue in fiscal year 2007, compared to 20% of total revenue in fiscal year 2006. There were no other clients that accounted for 10% or more of total revenue in either year. Higher concentration of revenue with a single customer or a limited group of clients creates increased revenue risk if one of these clients significantly reduces its demand for our services.

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

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

Cost of Services

Beginning in fiscal year 2007, the Company classified certain expenses, which had been previously reported within Cost of services as Selling, general and administrative expense. The three changes are:

Solution Development/Support: Costs associated with our Behavioral Analytics solution development teams and other Managed services administrative and support personnel will be classified as Selling, general and administrative expense. When these resources are working specifically on client revenue generating activities, their direct costs will be classified as Cost of services.

Account Management: Costs associated with our vertical industry teams, made up of industry experts, account partners and project managers, will be classified as Selling, general and administrative expense. When these resources are working specifically on client revenue generating activities, their direct costs will be classified as Cost of services.

Delivery Executive/Support: Costs associated with overall delivery executive management and administrative support personnel will be classified as Selling, general and administrative expense.

In prior years, the employees who worked on Managed services engagements and account management functions performed a variety of tasks all of which were classified as cost of services. Beginning in 2007, many of these employees were more focused on selling and general administrative tasks, which is why we now classify

non-client revenue generating activities as Selling, general and administrative expenses. We feel this revised classification provides a clearer understanding of the key profit/loss drivers and investments in our business. These changes in classification are the result of the ongoing evolution of our business model from Consulting to Managed services and the investments we are making to build market share and generate competitive advantages with our Behavioral Analytics Service Line. The changes will only be reported prospectively as the Company cannot accurately and reliably estimate prior periods under the new approach.

As a result of these changes, in fiscal year 2007 Cost of services decreased and Selling, general and administrative expense increased by $18.3 million, including $4.7 million of stock-based compensation. The impact of these changes in classification is further described in the discussion below.

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

Cost of services in fiscal year 2007 was $58.5 million, or 66% of Services revenue, compared to $58.6 million, or 81% of Services revenue, in fiscal year 2006. The slight decrease in cost was primarily due to the reclassification of $18.3 million of non-revenue generating costs related to account management, solution development/support, and delivery executive/support as discussed above that was almost completely offset by higher internal and external resource costs of $8.6 million, increased stock-based compensation expenses of $4.1 million, increased Behavioral Analytics amortized implementation costs net of deferrals of $3.1 million, and higher third party support costs that related to the increase in Integrated Contact Solutions Managed service revenue of $1.8 million. The percentage decrease is primarily due to cost reclassifications for non-revenue generating costs (as discussed above) of 21% and increased utilization of our Consulting services resources of 2%, partially offset by increased stock-based compensation including bonuses paid with stock awards of 5% and other small decreases.

Cost of Product

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

Rebates fluctuate with the volume of Cisco product sold, and are based on a percentage of our cost for the product. Eligibility for these rebates is determined by our ability to meet vendor-established performance criteria, some of which are outside our control. In the first half of 2006, we recognized these rebates in our financial statements in the period when contingencies associated with the contractual payment were resolved. In the second half of fiscal year 2006, we began to recognize the value of these rebates in the period we sold the product because we historically met all required criteria and had the ability to reasonably estimate the value of these rebates.

Cost of product in fiscal year 2007 was $7.0 million, or 76% of Product revenue, compared to $10.2 million, or 75% of Product revenue in fiscal year 2006. The cost decrease is primarily due to the decrease in Product revenue and changes in our treatment of earned rebates. The percentage increase was primarily due to the mix of vendor specific products sold in fiscal year 2007 and the change in our treatment of rebates.

Selling, General and Administrative

Selling, general and administrative expenses consist primarily of salaries, incentive compensation, commissions and employee benefits for business development, account management, solution development/

support, marketing and administrative personnel, as well as facilities cost, a provision for uncollectible amounts and costs for our technology infrastructure and applications. The personnel costs included here are net of any labor costs directly related to the generation of revenue, which are represented in Cost of services. Prior to 2007, all costs related to account management and solution development/support and delivery executive/support personnel were included in Cost of services.

Selling, general and administrative expenses increased $21.8 million to $47.1 million in fiscal year 2007 from $25.3 million in fiscal year 2006. This increase is primarily due to the change in the classification of non-revenue generating costs associated with account management, solution development/support and delivery executive/support personnel of $18.3 million as discussed above. Additional increases in the expenses were in cash and stock-based compensation of $1.7 million due to new hires and increased bonuses, audit and tax fees of $0.4 million mainly due to Sarbanes-Oxley compliance fees and incremental outside tax support, facilities cost of $0.6 million due to additional leased space and recruiting expense of $0.2 million due to increased staffing requirements.

Severance and Related Costs

To improve operating efficiencies we established two business units aligned along our primary Service Lines, Behavioral Analytics and Integrated Contact Solutions in late 2007. As part of the company s restructuring, key functions were reviewed and evaluated, and 41 positions were eliminated in late 2007. This helped facilitate the realignment of the business into these two primary business units. The position reductions are expected to generate annual cash savings of nearly $8 million. In addition, the restructuring should deliver an additional $1 million of cash savings from additional compensation adjustments and reduction in non-billable expenses. See Note Three Severance and Related Costs of the Notes to Consolidated Financial Statements included in Part II Item 8 of this Form 10-K.

Severance and related costs were $1.3 million in fiscal year 2007 compared to $0.7 million in fiscal year 2006. The $1.3 million of expense recorded in fiscal year 2007 is primarily related to severance and benefits due to the 41 employees who were terminated in the fourth quarter restructuring action. The $0.7 million of expense recorded in fiscal year 2006 is primarily related to $0.7 million of employee severance and related costs for the elimination of twelve positions in 2006.

Depreciation

Depreciation expense increased $1.1 million, or 52%, to $3.2 million in fiscal year 2007 compared to $2.1 million in fiscal year 2006. The increase in depreciation is primarily related to an increased rate of investment in our Behavioral Analytics Service Line.

Amortization of Intangibles

Amortization of intangibles remained constant at $0.4 million in fiscal years 2007 and 2006.

Operating Loss

Primarily as a result of the factors described above, we experienced an operating loss of $20.3 million for fiscal year 2007, compared to an operating loss of $11.8 million for fiscal year 2006.

Interest and Other Income (Expense), net

Non-operating interest and other income (expense) increased $0.8 million to $1.5 million in fiscal year 2007, compared to $0.7 million in fiscal year 2006. The $0.8 million increase was primarily related to higher average cash balances in 2007 because of the cash raised in the December 2006 rights offering, higher yields on our investments in 2007 and the impact of favorable exchange rates on an intercompany settlement in 2007.

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Income Tax Benefit (Provision)

The income tax benefit was $0.1 million in fiscal year 2007, compared to an expense of $0.1 million in fiscal year 2006. As of December 29, 2007, total deferred tax assets of $48.8 million are offset by a valuation allowance of $48.6 million. The income tax benefit in 2007 resulted from a reversal of $0.1 million of the valuation allowance primarily related to certain state net operating losses (NOL s). We expect to utilize these NOL s before they expire. The level of uncertainty in predicting when we will return to profitability, sufficient to utilize our net U.S. and non-U.S. operating losses and realize our remaining deferred tax assets, requires that an income tax valuation allowance be recognized in the financial statements.

Net Loss Available to Common Stockholders

We reported a net loss available to common stockholders of $20.1 million in fiscal year 2007 compared to a net loss available to common stockholders of $12.6 million in fiscal year 2006. These losses include dividends paid to preferred shareholders of $1.4 million and $1.5 million in 2007 and 2006, respectively. We reported a net loss of $2.40 per share on a basic and diluted basis in fiscal year 2007, compared to a net loss of $1.86 per share on a basic and diluted basis in fiscal year 2006.

Year Ended December 30, 2006 Compared with the Year Ended December 31, 2005

Revenue

	For the Fiscal Years Ended			
	2006		2005	
	Dollars in Millions	% of Net Revenue	Dollars in Millions	% of Net Revenue
Revenue:				
Consulting services	$ 44.3	52%	$ 46.0	61%
Managed services	27.7	32%	19.6	26%
Services revenue	**72.0**	**84%**	**65.6**	**87%**
Product	13.6	16%	9.7	13%
Net revenue	**85.6**	**100%**	**75.3**	**100%**
Reimbursed expenses	4.2		3.7	
Total revenue	**$ 89.8**		**$ 79.0**	

Net revenue for fiscal year 2006 was total revenue excluding reimbursable expenses that are billed to our clients. Our net revenue increased 14% to $85.6 million in fiscal year 2006, up $10.3 million from $75.3 million in fiscal year 2005.

Revenue from Consulting services decreased 4% to $44.3 million in fiscal year 2006, from $46.0 million in fiscal year 2005. Consulting services revenue represented 52% and 61% of net revenue for fiscal years 2006 and 2005, respectively. The decrease in Consulting services revenue was primarily due to decreased demand for our traditional CRM Consulting services and was, partially offset by the 37% growth of our Integrated Contact Solutions Service Line. Spending by our Consulting services clients may fluctuate between periods due to the short-term nature of these agreements.

Utilization of billable consulting personnel was 73% for fiscal year 2006, compared to 72% for fiscal year 2005. Utilization is defined as billed time as a percentage of total available time. We experienced pricing pressures that resulted in an average hourly billing rate of $151 for fiscal year 2006 and $154 for fiscal year 2005.

Revenue from Managed services increased to $27.7 million in fiscal year 2006 from $19.6 million in fiscal year 2005. Managed services revenue represented 32% and 26% of net revenue for fiscal years 2006 and 2005,

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respectively. The increase in Managed services revenue resulted from the continued growth in our Integrated Contact Solutions Service Line and the transition of several Behavioral Analytics projects to the subscription phase of their respective arrangements.

Revenue from the sale of Product increased $3.9 million, or 40%, to $13.6 million in fiscal year 2006 from $9.7 million in fiscal year 2005. Revenue from the sale of Product represented 16% and 13% of net revenue for fiscal years 2006 and 2005, respectively. This increase was primarily driven by the growth in our Integrated Contact Solutions Service Line. There are significant variances in size among individual engagements within this Service Line and the Company is not always selected as the Product supplier for the engagement. As a result, annual and quarterly Product revenue may fluctuate significantly.

Net revenue from North American operations increased 16% to $81.5 million in fiscal year 2006, up $11.5 million from $70.0 million in fiscal year 2005. International operations net revenue (which primarily represents net revenue from Europe and Australia) decreased $1.2 million, or 23%, to $4.1 million in fiscal year 2006 from $5.3 million in fiscal year 2005. As a percentage of consolidated net revenue, net revenue from International operations represented 5% and 7% of net revenue for fiscal years 2006 and 2005, respectively.

Our revenue concentration increased as our top 5 clients accounted for 42% and 37% of total revenue in fiscal years 2006 and 2005, respectively. The top 10 clients accounted for 62% and 56% of total revenue for fiscal years 2006 and 2005, respectively. In addition, the top 20 clients accounted for 79% of total revenue for fiscal year 2006 and 72% of total revenue for fiscal year 2005. One customer, United Healthcare Services, Inc., accounted for 20% of total revenue for fiscal year 2006 and 13% of total revenue for fiscal year 2005, respectively. Higher concentration of revenue with a single customer or a limited group of clients can result in increased revenue risk should one of these clients significantly reduce its demand for our services.

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

Cost of revenue before reimbursed expenses was primarily comprised of labor costs including salaries, fringe benefits, and incentive compensation of our delivery personnel, third-party pass through costs related to our Managed services and the cost of third-party product. Cost of revenue before reimbursed expenses also included employee costs for travel expenses, training, laptop computer leases and other expenses of a non-billable nature. Cost of revenue before reimbursed expenses excludes depreciation and amortization.

Cost of revenue before reimbursed expenses as a percentage of net revenue was driven primarily by the prices we obtained for our solutions and services, the billable utilization of our Consulting services delivery personnel and the relative mix of business between Consulting services, Managed services and Product. The cost of Product was impacted by our ability to qualify for rebates from our largest Product vendor. The amount of the rebates varied with the size of our Product revenue, as the rebates were calculated as a percentage of the specific Product cost. Eligibility for these rebates was determined by our ability to meet vendor-established performance criteria, some of which were outside our control. Prior to the third quarter of 2006, we recognized these rebates in our financial statements in the period when any contingency associated with the contractual payment was resolved. In the second half of 2006, we began to recognize the value of these rebates in the period we purchased the product because of our historical performance of meeting all required criteria and our ability to reasonably estimate the value of these rebates. The impact of this change resulted in a $0.5 million reduction of Product cost in 2006.

Cost of revenue before reimbursed expenses increased $12.0 million, or 21%, to $68.8 million in fiscal year 2006 from $56.8 million in fiscal year 2005. The increase was primarily due to our investment in personnel to develop and support our Behavioral Analytics and Integrated Contact Solutions, higher third-party support costs driven by growth in our Integrated Contact Solutions related Managed services revenue and increased Product costs, net of rebates, due to higher Product revenue. Product rebates recognized in fiscal year 2006 totaled $2.6 million compared to $1.2 million in fiscal year 2005. Cost of revenue before reimbursed expenses as a percentage of net revenue increased to 80% in fiscal year 2006 compared to 75% in fiscal year 2005. The increase in the percentage in fiscal year 2006 was primarily due to our investment in personnel to develop and

support our Behavioral Analytics and Integrated Contact Solutions and higher third-party support costs driven by growth in our Integrated Contact Solutions related Managed services revenue.

Selling, General and Administrative

Selling, general and administrative expenses consist primarily of salaries, incentive compensation, commissions and employee benefits for business development, marketing, administrative personnel, facilities cost, a provision for uncollectible amounts and costs for our technology infrastructure and applications.

Selling, general and administrative expenses increased $4.9 million, or 24%, to $25.3 million in fiscal year 2006 from $20.4 million in fiscal year 2005. This increase was primarily the result of increased personnel costs required to support our Behavioral Analytics and Integrated Contact Solutions Service Lines.

Severance and Related Costs

In fiscal years 2006 and 2005, in response to the current business environment and shifting skill and geographic requirements, a number of cost reduction activities were undertaken, principally consisting of personnel reductions. Annual savings related to the cost reduction actions in fiscal year 2006 were $2.4 million and were realized in fiscal year 2007. Annual savings related to the cost reduction actions in fiscal year 2005 were $1.6 million and were realized in fiscal year 2006. Facility costs related to office space reductions and office closures in fiscal years 2002 and 2001 were paid pursuant to contractual lease terms through fiscal year 2007. Substantially all severance and related costs associated with cost reduction activities in 2006 and 2005 were paid by the end of the first quarter of 2007, pursuant to agreements entered into with affected employees.

Severance and related costs increased $0.3 million, to $0.7 million in fiscal year 2006 compared to $0.4 million in fiscal year 2005. The $0.7 million of expense recorded in fiscal year 2006 was primarily related to employee severance and related costs for the elimination of twelve positions. In fiscal year 2005, severance and related costs of $0.4 million reflected $0.6 million of employee severance and related costs for the elimination of nine positions, offset by favorable adjustments of $0.2 million primarily related to previously estimated facility and severance cost accruals.

Depreciation

Depreciation expense decreased by $3.1 million, or 60%, to $2.1 million in fiscal year 2006 compared to $5.2 million in fiscal year 2005. The decrease in depreciation was primarily because assets from our information technology infrastructure and our Marketing Managed services became fully depreciated.

Amortization of Intangibles

Amortization of intangibles decreased $0.1 million, or 20%, to $0.4 million in fiscal year 2006 compared to $0.5 million in fiscal year 2005. The decrease was primarily because intangible assets related to the Interelate Acquisition became fully amortized.

Operating Loss

Primarily as a result of the previously-described business conditions, we experienced an operating loss of approximately $11.8 million for fiscal year 2006, compared to an operating loss of approximately $8.0 million for fiscal year 2005.

Interest and Other Income (Expense), net

Non-operating interest and other income (expense) increased $0.3 million, or 75%, to $0.7 million in fiscal year 2006 compared to $0.4 million in fiscal year 2005. The $0.3 million increase was primarily related to higher yields on our investments.

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Income Tax Benefit (Provision)

Income tax provision was $0.1 million in fiscal year 2006 compared to almost $0 in fiscal year 2005. As of December 30, 2006 and December 31, 2005, total deferred tax assets of $56.6 million and $54.7 million were fully offset by valuation allowances. The level of uncertainty in predicting when we will return to acceptable levels of profitability, sufficient to utilize our net U.S. and non-U.S. operating losses and realize our deferred tax assets required that a full income tax valuation allowance be recognized in the financial statements.

Net Loss Available to Common Stockholders

We reported a net loss available to common stockholders of $12.6 million in fiscal year 2006 compared to a net loss available to common stockholders of $9.1 million in fiscal year 2005. These losses were after taking into consideration dividends paid to preferred shareholders of $1.5 million in 2006 and 2005. We reported a net loss of $1.86 per share on a basic and diluted basis in fiscal year 2006 compared to a net loss of $1.43 per share on a basic and diluted basis in fiscal year 2005.

Liquidity and Capital Resources

Introduction

Our principal capital requirements are to fund working capital needs, capital expenditures for infrastructure and our Behavioral Analytics Service Line, other investments in support of revenue generation and growth and payment of Series B stock dividends. As of December 29, 2007, our principal current capital resources consist of our cash and cash equivalent balances of $21.4 million, which includes $2.1 million in foreign bank accounts, and restricted cash of $2.5 million. Our cash and cash equivalents position decreased $10.2 million, or 32%, as of December 29, 2007 compared to $31.6 million as of December 30, 2006.

In fiscal year 2007, the decrease in cash was primarily due to the operating loss, capital expenditures, acquisition of treasury stock, and dividend payments partially offset by positive working capital management. In December 2006, the increase in cash was primarily due to the completion of a rights offering that resulted in net proceeds to the Company of $17.8 million, partially offset by operating losses, capital expenditures, dividend payments and working capital requirements. Restricted cash increased to $2.5 million as of December 29, 2007 compared to $0.3 million at December 30, 2006. The $2.2 million increase in restricted cash was used as collateral for a letter of credit issued in support of our capital lease obligation. See Bank Facility below for a description of the contractual requirements restricting the use of this cash.

Cash Flows from Operating Activities

The company improved its cash flows from operating activities by $4.4 million, generating $1.4 million of cash in fiscal year 2007 compared to using $3.0 million of cash during fiscal year 2006. This improvement was largely the result of an increased use of stock-based compensation, prepayments from our clients related to our Managed services contracts and improved working capital management partially offset by a larger net loss and payments of deferred Managed services costs including Behavioral Analytics deployment costs and third party maintenance contracts. Net cash outflows of $3.0 million in fiscal year 2006 arose primarily from operating losses, payment of deferred Managed services costs and an increase in accounts receivable, annual corporate insurance payments and incentive compensation largely offset by prepayments from our clients related to our Managed services contracts. Average Days Sales Outstanding (DSO) of 47 days at December 29, 2007 represented a decrease of 2 days compared to 49 days at December 30, 2006. We do not expect any significant collection issues with our clients. At December 29, 2007, there remained $0.8 million of unpaid severance and related costs. See Note Three Severance and Related Costs of the Notes to Consolidated Financial Statements included in Part II Item 8 of this Form 10-K.

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Cash Flows from Investing Activities

The Company used $4.5 million of cash during fiscal year 2007 primarily for capital expenditures. Included in this figure was $1.5 million of software and hardware and $0.5 million to build out a new data center both, related to the expansion of our Behavioral Analytics Service Line. During fiscal year 2006, the sale of short-term investments provided $4.0 million, which was offset by capital expenditures and other of $4.0 million. We currently expect our capital expenditures to be between $6 and $8 million for fiscal year 2008 and plan on funding these purchases with capital leases.

Cash Flows from Financing Activities

The Company used $6.9 million of cash during fiscal year 2007 as compared to generating $16.6 million in cash during fiscal year 2006 from financing activities. Net cash outflows of $6.9 million during fiscal year 2007 were primarily attributable to $3.6 million of cash used to acquire treasury stock, $2.2 million used to fund the required deposit of cash security for the credit line and $1.5 million used to pay dividends on Series B convertible preferred stock (Series B stock), partially offset by proceeds of $0.4 million from the exercise of stock options and employee stock purchases. The treasury stock acquired reflects shares that were obtained to meet employee tax obligations associated with stock award vestings. Prior to February 1, 2007, the shares associated with these employee tax obligations were cancelled and not recorded as treasury stock.

Net cash inflows of $16.6 million during fiscal year 2006 were primarily attributable to $17.8 million of net proceeds from the issuance of 1,001,342 shares in connection with the rights offering offset by cash dividend payments on Series B stock of approximately $1.5 million.

A semi-annual dividend payment of approximately $0.6 million is expected to be paid in future periods on the Series B stock. The amount of each such dividend would decrease by any conversions of the Series B stock into common stock, although any such conversions would require that we pay accrued but unpaid dividends at time of conversion.

Liquidity

Our near-term capital resources consist of our current cash balances together with anticipated future cash flows and financing from capital leases. Our balance of cash and cash equivalents was $21.4 million as of December 29, 2007 and $31.6 million as of December 30, 2006. In addition, our restricted cash of $2.5 million with Bank of America (the Bank) at December 29, 2007 is available to support letters of credit issued under our credit facility (as described below) to support collateral requirements for our capital lease agreements and to accommodate a credit requirement at the Bank associated with the purchase and transfer of foreign currencies and credit card payments. For 2008, we will increase the use of stock-based compensation compared to 2007. See Salary Replacement Program under Note Fifteen Stock-Based Compensation of the Notes to Consolidated Financial Statements included in Part II Item 8 of this Form 10-K.

We anticipate that our current unrestricted cash resources, together with capital lease financing, other internally generated funds and other financing alternatives, will be sufficient to satisfy our expected short-term working capital and capital expenditure needs for the next twelve months. If, however, our operating activities, capital expenditure requirements or net cash needs differ materially from current expectations due to uncertainties surrounding the current capital market, credit and general economic conditions, competition, or suspense or cancellation of a large project, there is no assurance that we would have access to additional external capital resources on acceptable terms.

Bank Facility

The Company maintains a Loan Agreement with the Bank. The maximum principal amount of the secured line of credit under the agreement (the Facility) increased to $5.0 million at year end 2007 from $2.0 million at

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year end 2006. The Facility requires the Company to maintain a minimum cash and cash equivalent balance within a secured account at the Bank. The balance in the secured account cannot be less than the outstanding balance drawn on the Facility line of credit, and letter of credit obligations under the Facility, plus a de minimis reserve to accommodate a Bank credit requirement associated with the purchase and transfer of foreign currencies and credit card payments. Available credit under the Facility has been reduced by $2.5 million related to letters of credit issued under the Facility to support our capital lease obligations and a Bank credit requirement associated with the purchase and transfer of foreign currencies and credit card payments. As a result, $2.5 million remains available under the Facility at December 29, 2007. Loans under the Facility bear interest at the Bank s prime rate or, at the Company s election, an alternate rate of LIBOR (London InterBank Offering Rate) plus 0.75%. We did not have any borrowings or interest expense under the Facility during fiscal years 2007 and 2006, respectively. See Note Twelve Line of Credit of the Notes to Consolidated Financial Statements included in Part II Item 8 of this Form 10-K.

Accounts Receivable Customer Concentration

At December 29, 2007, one customer, United HealthCare Services, Inc., accounted for 28% of total net accounts receivable. We collected 67% of that amount through March 11, 2008. Of the total December 29, 2007 gross accounts receivable, we collected 65% as of March 11, 2008. Because we have a high percentage of our revenue dependent on a relatively small number of clients, delayed payments by a few of our larger clients could result in a reduction of our available cash.

Capital Lease Obligations

Capital lease obligations at December 29, 2007 were $1.5 million. We entered into a capital lease agreement with a lease company to lease hardware and software. We expect capital lease obligations to increase $5-$6 million during fiscal year 2008 as we continue to expand our investment in Behavioral Analytics infrastructure. At the current time the Company is required to issue an irrevocable letter of credit for 60% of the lease amount as additional consideration for the duration of the lease on future leases. There were no capital lease obligations at December 30, 2006.

Contractual Obligations

Cash will also be required for operating leases and non-cancelable purchase obligations as well as various commitments reflected as liabilities on our balance sheet at December 29, 2007. These commitments are as follows:

Contractual Obligations (In millions)	Total	2008	2009-2010	2011-2012	Thereafter
Letters of credit	$ 2.3	$	$ 2.3	$	$
Operating leases	$ 5.8	$ 1.9	$ 2.5	$ 0.6	$ 0.8
Capital leases	$ 2.0	$ 0.7	$ 1.3	$	$
Severance and related costs	$ 0.8	$ 0.8	$	$	$
Purchase obligations	$ 4.4	$ 4.4	$	$	$
Total	$ 15.3	$ 7.8	$ 6.1	$ 0.6	$ 0.8

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

Letters of Credit

Reflects standby letters of credit issued as collateral for capital leases. The terms of our Bank Facility requires us to deposit a like amount of cash into a restricted cash account at the Bank for the duration of the letter

of credit commitment period. The above amounts reflect the face amount of these letters of credit that expire in each period presented. To the extent these letters of credit expire without a claim being made, the cash deposited in the restricted cash account will be transferred back to an unrestricted cash account.

Leases

Reflects leases entered into by the Company for technology and office equipment as well as office and data center space. Liabilities for capital leases are reflected on our balance sheet as of December 29, 2007.

Severance and Related Costs

Severance and related costs reflect payments the Company is required to make in future periods for severance and other related costs due to cost reduction activities in fiscal year 2007. Liabilities for these required payments are reflected on our balance sheet as of December 29, 2007.

Purchase Obligations

Purchase obligations include both commitments reflected as liabilities on our balance sheet as of December 29, 2007 as well as non cancellable obligations to purchase goods or services in the future.

Recent Accounting Pronouncements

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The company is required to adopt SFAS 159 beginning in fiscal year 2008. The company does not expect to elect the fair value option permitted under SFAS 159 so adoption will have no impact on its financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements , which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for fiscal years beginning after November 15, 2007. The Company intends to adopt SFAS 157 effective January 1, 2008 and does not expect the implementation to have a material effect on its consolidated financial statements.

In July 2006, the FASB issued FIN 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109, Accounting for Income Taxes. The Interpretation addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on derecognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures.

The Company adopted the provisions of FIN 48 on December 31, 2006. As a result of FIN 48 implementation, the Company recorded a $12.8 million decrease in the deferred tax assets associated with the net operating loss carryover, which is offset with a reduction to the valuation allowance with no net change to retained earnings. The Company had unrecognized tax benefits of $12.8 million as of December 31, 2006, the date of adoption.

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In June 2006, the FASB ratified a consensus opinion reached by EITF on EITF Issue 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation). The guidance in EITF Issue 06-3 requires disclosure in interim and annual financial statements of the amount of taxes on a gross basis, if significant, that are assessed by a governmental authority that are imposed on and concurrent with a specific revenue producing transaction between a seller and customer such as sales, use, value added and some excise taxes. Additionally, the income statement presentation (gross or net) of such taxes is an accounting policy decision that must be disclosed. The consensus in EITF Issue 06-3 is effective for interim and annual reporting periods beginning after December 15, 2006. The Company adopted EITF Issue 06-3 effective December 31, 2006. The Company presents these taxes on a net basis. The adoption of EITF Issue 06-3 did not have a material effect on the financial statements.

Item 7A. ***Quantitative and Qualitative Disclosures about Market Risk.***

We provide solutions to clients in a number of countries including the United States, Australia, Canada, Germany, Ireland and the United Kingdom. For the fiscal years ended December 29, 2007 and December 30, 2006, 6% and 11%, respectively, of our net revenue was denominated in foreign currencies. Historically, we have not experienced material fluctuations in our results of operations due to foreign currency exchange rate changes and do not expect to in the future. We do not currently engage in hedging foreign currency risk and do not expect to in the future.

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

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Item 8. ***Financial Statements and Supplementary Data.***

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS OF eLOYALTY CORPORATION

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

eLoyalty Corporation:

We have audited the accompanying consolidated balance sheets of eLoyalty Corporation (a Delaware corporation) and Subsidiaries (the Company) as of December 29, 2007 and December 30, 2006, and the related statements of operations, changes in stockholders equity and comprehensive loss, and cash flows for each of the two years ended December 29, 2007. Our audits of the basic financial statements included the financial statement schedule listed in the index appearing under Schedule II. We also have audited the Company s internal control over financial reporting as of December 29, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these financial statements and financial statement schedule and an opinion on the Company s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As discussed in Note fifteen to the financial statements, the Company has adopted Financial Accounting Standards Board Statement No. 123(R), *Share-Based Payments* (SFAS 123R) in 2006.

As discussed in Note Seven to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards Interpretation No. 48, *Accounting for Uncertainty in Income Taxes,* on December 31, 2006.

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In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 29, 2007 and December 30, 2006, and the results of its operations and its cash flows for each of the two years ended December 29, 2007 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 29, 2007, based on criteria established in *Internal Control Integrated Framework* issued by COSO.

/s/ GRANT THORNTON LLP

Chicago, Illinois

March 11, 2008

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of eLoyalty Corporation:

In our opinion, the consolidated statements of operations, changes in stockholders equity and comprehensive loss and cash flows, for the year ended December 31, 2005 present fairly, in all material respects, the results of operations and cash flows of eLoyalty Corporation and its subsidiaries (the Company) for the year ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule for the year ended December 31, 2005 presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audit. We conducted our audit of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

Chicago, Illinois

March 13, 2006, except for the 2005 stock based compensation disclosures in Note Fifteen to the consolidated financial statements, as to which the date is March 9, 2007 and except for the segment disclosures in Note Nineteen to the consolidated financial statements, as to which the date is March 10, 2008

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eLOYALTY CORPORATION

CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

	December 29, 2007	December 30, 2006
ASSETS:		
Current Assets:		
Cash and cash equivalents	$ 21,412	$ 31,645
Restricted cash	2,455	283
Receivables, net	11,322	12,816
Prepaid expenses	8,465	5,352
Other current assets	1,074	2,125
Total current assets	44,728	52,221
Equipment and leasehold improvements, net	7,391	4,793
Goodwill	2,643	2,643
Intangibles, net	828	1,034
Other long-term assets	4,461	3,877
Total assets	$ 60,051	$ 64,568
LIABILITIES AND STOCKHOLDERS EQUITY:		
Current Liabilities:		
Accounts payable	$ 2,997	$ 4,247
Accrued compensation and related costs	5,555	3,479
Unearned revenue	11,772	7,435
Other current liabilities	3,783	4,420
Total current liabilities	24,107	19,581
Long-term unearned revenue	7,416	5,411
Other long-term liabilities	1,625	60
Total liabilities	33,148	25,052
Redeemable Series B convertible preferred stock, $0.01 par value; 5,000,000 shares authorized and designated; 3,745,070 and 4,098,369 shares issued and outstanding with a liquidation preference of $19,768 and $21,633 at December 29, 2007 and December 30, 2006, respectively	19,100	20,902
Stockholders Equity:		
Preferred stock, $0.01 par value; 35,000,000 shares authorized; none issued and outstanding		
Common stock, $0.01 par value; 50,000,000 shares authorized; 9,885,458 and 9,078,794 shares issued at December 29, 2007 and December 30, 2006; and 9,735,492 and 9,078,794 outstanding at December 29, 2007 and December 30, 2006, respectively	99	91
Additional paid-in capital	172,483	162,059
Accumulated deficit	(158,548)	(139,810)
Treasury stock, at cost, 149,966 shares at December 29, 2007	(2,731)	
Accumulated other comprehensive loss	(3,500)	(3,726)
Total stockholders equity	7,803	18,614

Total liabilities and stockholders equity	$	60,051	$	64,568

See accompanying notes to consolidated financial statements.

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eLOYALTY CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	For the Fiscal Years Ended		
	2007	**2006**	**2005**
Revenue:			
Services	$ 88,046	$ 71,980	$ 65,556
Product	9,185	13,579	9,710
Revenue before reimbursed expenses (net revenue)	97,231	85,559	75,266
Reimbursed expenses	4,874	4,269	3,742
Total revenue	102,105	89,828	79,008
Operating Expenses:			
Cost of services	58,496	58,604	49,477
Cost of product	6,993	10,183	7,331
Cost of revenue before reimbursed expenses	65,489	68,787	56,808
Reimbursed expenses	4,874	4,269	3,742
Total cost of revenue, exclusive of depreciation and amortization shown below	70,363	73,056	60,550
Selling, general and administrative	47,075	25,328	20,385
Severance and related costs	1,333	737	411
Depreciation	3,186	2,095	5,151
Amortization of intangibles	423	370	532
Total operating expenses	122,380	101,586	87,029
Operating loss	(20,275)	(11,758)	(8,021)
Interest and other income (expense), net	1,484	681	374
Loss before income taxes	(18,791)	(11,077)	(7,647)
Income tax benefit (provision)	53	(71)	17
Net loss	(18,738)	(11,148)	(7,630)
Dividends related to Series B preferred stock	(1,405)	(1,464)	(1,471)
Net loss available to common stockholders	$ (20,143)	$ (12,612)	$ (9,101)
Basic net loss per common share	$ (2.40)	$ (1.86)	$ (1.43)
Diluted net loss per common share	$ (2.40)	$ (1.86)	$ (1.43)
Shares used to calculate basic net loss per share	8,399	6,769	6,359
Shares used to calculate diluted net loss per share	8,399	6,769	6,359

Stock-based compensation, primarily restricted stock, included in individual line items above:			
Cost of services	$ 1,004	$ 1,632	$ 1,154
Selling, general and administrative	9,444	2,386	1,462
Severance and related costs	196		(25)

See accompanying notes to consolidated financial statements.

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eLOYALTY CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	For the Fiscal Years Ended		
	2007	2006	2005
Cash Flows from Operating Activities:			
Net loss	$ (18,738)	$ (11,148)	$ (7,630)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	3,609	2,465	5,683
Stock-based compensation	10,448	4,018	2,616
Provision for uncollectible amounts	168		
Deferred income taxes	(129)		
Changes in assets and liabilities:			
Receivables	1,466	(1,977)	344
Prepaid expenses	(3,533)	(5,314)	(319)
Other assets	1,622	(771)	332
Accounts payable	(1,271)	2,266	457
Accrued compensation and related costs	2,057	(1,962)	(1,958)
Unearned revenue	6,233	8,306	(800)
Other liabilities	(550)	1,113	(726)
Net cash provided by (used) in operating activities	1,382	(3,004)	(2,001)
Cash Flows from Investing Activities:			
Sale of short-term investments		4,000	3,772
Purchase of short-term investments			(797)
Capital expenditures and other	(4,520)	(3,979)	(1,502)
Net cash (used in) provided by investing activities	(4,520)	21	1,473
Cash Flows from Financing Activities:			
Proceeds from rights offering, net	24	17,754	
(Increase) decrease in restricted cash	(2,172)	241	174
Acquisition of treasury stock	(3,637)		
Payment of Series B dividends	(1,468)	(1,464)	(1,480)
Proceeds from stock compensation and employee stock purchase plans, net	422	67	
Principal payments under capital lease obligations	(27)		
Net cash (used in) provided by financing activities	(6,858)	16,598	(1,306)
Effect of exchange rate changes on cash and cash equivalents	(237)	179	(410)
(Decrease) increase in cash and cash equivalents	(10,233)	13,794	(2,244)
Cash and cash equivalents, beginning of period	31,645	17,851	20,095
Cash and cash equivalents, end of period	$ 21,412	$ 31,645	$ 17,851
Non-Cash Investing and Financing Transactions:			
Capital lease obligations incurred	$ 1,518	$	$

Capital equipment purchased on credit	1,518		
Change in net unrealized security gain	451		
Supplemental Disclosures of Cash Flow Information:			
Cash refunded for income taxes, net	$ 1,192	$	$ 17
Interest paid	(97)		

See accompanying notes to consolidated financial statements.

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eLOYALTY CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

AND COMPREHENSIVE LOSS

(In thousands, except share data)

	Common Stock Issued							
	Shares	**Amount**	**Additional Paid-in Capital**	**(Accumulated Deficit)**	**Treasury Stock**	**Accumulated Other Comprehensive Loss**	**Unearned Compensation**	**Total Stockholders Equity**
Balance, January 1, 2005	7,407,065	$ 74	$ 150,659	$ (121,032)	$	$ (3,451)	$ (7,287)	$ 18,963
Net loss				(7,630)				(7,630)
Foreign currency translation						(496)		(496)
Comprehensive loss								(8,126)
Issuance of restricted common stock	373,734	4	1,992				(1,996)	
Amortization/forfeitures of unearned compensation	(219,719)	(2)	(1,490)				3,342	1,850
Series B conversions	50,835		259					259
Preferred stock dividend			(1,471)					(1,471)
Balance, December 31, 2005	7,611,915	$ 76	$ 149,949	$ (128,662)	$	$ (3,947)	$ (5,941)	$ 11,475
Net loss				(11,148)				(11,148)
Foreign currency translation						221		221
Comprehensive loss								(10,927)
Reclassification of unearned compensation			(5,941)				5,941	
Rights offering, net	1,001,342	10	17,744					17,754
Issuance of common stock for option awards exercised	11,963		67					67
Issuance of common stock related to employee stock programs	754,718	7	407					414
Amortization/forfeitures of unearned compensation	(302,743)	(2)	1,289					1,287
Series B conversions	1,599		8					8
Preferred stock dividend			(1,464)					(1,464)
Balance, December 30, 2006	9,078,794	$ 91	$ 162,059	$ (139,810)	$	$ (3,726)	$	$ 18,614
Net loss				(18,738)				(18,738)
Foreign currency translation						(225)		(225)
Unrealized gain on marketable securities						451		451
Comprehensive loss								(18,512)
Rights offering, net			24					24
Issuance of common stock for option awards exercised	22,279		257					257
	639,998	6	2,947					2,953

Issuance of common stock related to employee stock programs								
Amortization/forfeitures of unearned compensation	(165,142)	(1)	7,708					7,707
Purchase of treasury shares					(3,637)			(3,637)
Issuance of treasury shares	(43,770)		(906)		906			
Series B conversions	353,299	3	1,799					1,802
Preferred stock dividend			(1,405)					(1,405)
Balance, December 29, 2007	9,885,458	$ 99	$ 172,483	$ (158,548)	$ (2,731)	$ (3,500)	$	$ 7,803

See accompanying notes to consolidated financial statements.

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eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in millions, except share and per share data)

Note One Description of Business

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

eLoyalty is focused on growing and developing its business through two primary Service Lines: Behavioral Analytics and Integrated Contact Solutions. Through these Service Lines and through our traditional CRM business, the Company generates three types of revenue:
(1) Consulting services revenue, which is generally project-based and sold on a time and materials or fixed-fee basis; (2) Managed services revenue, which is recurring, annuity revenue that is secured through long-term (generally one to five year) contracts; and (3) Product revenue, which is generated through the resale of third-party software and hardware.

Note Two Summary of Significant Accounting Policies

Fiscal Year-End

The fiscal year-end dates presented are December 29, 2007, December 30, 2006 and December 31, 2005.

Consolidation

The consolidated financial statements include the accounts of eLoyalty and all of its subsidiaries. All significant intercompany transactions have been eliminated.

Use of Estimates

The preparation of the financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those amounts.

Reclassifications and Revisions

Beginning in fiscal year 2007, the Company classified certain expenses, which had been previously reported within Cost of services, as Selling, general and administrative expense. The three changes are:

Solution Development/Support: Costs associated with our Behavioral Analytics solution development teams and other Managed services administrative and support personnel will be classified as Selling, general and administrative expense. When these resources are working specifically on client revenue generating activities, their direct costs will be classified as Cost of services.

Account Management: Costs associated with our vertical industry teams, made up of industry experts, account partners and project managers, will be classified as Selling, general and administrative expense. When these resources are working specifically on client revenue generating activities, their direct costs will be classified as Cost of services.

Delivery Executive/Support: Costs associated with overall delivery executive management and administrative support personnel will be classified as Selling, general and administrative expense.

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eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In prior years, the employees who worked on Managed services engagements and account management functions performed a variety of tasks all of which were classified as cost of services. Beginning in 2007 many of these employees are more focused on selling and general administrative tasks, which is why we now classify non client revenue generating activities as Selling, general and administrative expenses. We feel this revised classification provides a clearer understanding of the key profit/loss drivers and investments in our business. These changes in classification are the result of the ongoing evolution of our business model from Consulting to Managed services and the investments we are making to build market share and generate competitive advantages with our Behavioral Analytics Service Line. The changes will only be reported prospectively as the Company cannot accurately estimate prior periods under the new approach.

As a result of these changes, for the fiscal year ended 2007 Cost of services decreased and Selling, general and administrative expense increased by $18.3 million, including $4.7 million of stock-based compensation.

Revenue Recognition

Behavioral Analytics Service Line

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

Managed services revenue included in the Behavioral Analytics Service Line consists of planning, deployment, training, and subscription fees. The planning, deployment and training fees, which are considered to be installation fees related to the long-term subscription contract are deferred until the installation is complete and are then recognized over the term of the applicable subscription contract. The terms of these subscription contracts generally range from three to five years. As of December 29, 2007 and December 30, 2006, this deferred revenue totaled $5.4 million and $5.5 million, respectively. Installation costs incurred are deferred up to an amount not to exceed the amount of deferred installation revenue and additional amounts that are recoverable based on the contractual arrangement. Such costs are amortized over the term of the subscription contract. Costs in excess of the foregoing revenue amount are expensed in the period incurred. These deferred costs totaled $3.5 million as of December 29, 2007 and $3.7 million as of December 30, 2006.

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

Integrated Contact Solutions Service Line

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

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

eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

Within the Integrated Contact Solutions Service Line, Consulting services, Managed services and the resale of Product may be sold and delivered together. In arrangements that include the resale of software, SOP 97-2 requires determination of vendor specific objective evidence (VSOE) for each of the individual elements. If VSOE does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement is deferred until all elements of the arrangement without VSOE have been delivered to the client. If the remaining undelivered elements are post contract support (PCS) or other deliverables with similar attribution periods, the arrangement revenue is recognized ratably over the remaining service period. Revenue of $1.5 million and $2.1 million has been deferred as of December 29, 2007 and December 30, 2006, respectively, due to the lack of VSOE for elements within these arrangements. This revenue will be recognized when the elements without VSOE are delivered to the client or will be recognized ratably over the remaining service period.

Traditional CRM

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

Managed services revenue included in the traditional CRM Service Line consists of marketing application hosting, email fulfillment and remote application support. Revenue related to hosting services, generally a fixed monthly fee, is recognized as the services are performed for the client. Any related setup fee would be recognized over the contract period of the hosting arrangement. Revenue related to the email fulfillment services is recognized as the services are provided to the client. For example, the monthly email fulfillment fee is based on the number of emails distributed for the client. Contracts for remote application support can be based on a fixed fee or time and materials basis. Revenue is recognized ratably over the contract period for fixed fee support. Revenue is recognized as the services are provided to the client for time and material contracts.

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

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eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

Selling, General and Administrative

Selling, general and administrative expenses consist primarily of salaries, incentive compensation, commissions and employee benefits for business development, account management, solution development/support, marketing and administrative personnel, as well as facilities cost, a provision for uncollectible amounts and costs for our technology infrastructure and applications. The personnel costs included here are net of any labor costs directly related to the generation of revenue, which are represented in Cost of services. Prior to 2007, all costs related to account management and solution development/support and delivery executive/support personnel were included in Cost of services.

Loss Per Common Share

The Company calculates loss per share in accordance with Statement of Financial Accounting Standards (SFAS) No. 128, Earnings per Share. Basic net loss per common share has been computed by dividing the net loss available to common stockholders for each period presented by the weighted average shares outstanding. Diluted loss per common share has been computed by dividing the net loss available to common stockholders by the weighted average shares outstanding plus the dilutive effect of common stock equivalents, which consist of convertible preferred stock, restricted stock awards and options, using the treasury stock method. In periods in which there was a loss, the dilutive effect of common stock equivalents, which is primarily related to Series B stock, unvested restricted stock, unissued installment stock awards and stock options, was not included in the diluted loss per share calculation as it was antidilutive.

Fair Value of Financial Instruments

The carrying values of current assets and liabilities approximated their fair values as of December 29, 2007 and December 30, 2006.

Cash and Cash Equivalents

The Company considers all highly liquid investments readily convertible into known amounts of cash (with purchased maturities of three months or less) to be cash equivalents.

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eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Restricted Cash

Restricted cash principally represents cash as security for The Company s line of credit, letters of credit including letters of credit issued to support our capital lease obligations, plus a de minimis reserve to accommodate a bank credit requirement associated with the purchase and transfer of foreign currencies and credit card payments.

Short-term Investments

Short-term investments consisted of auction rate municipal bonds and auction rate preferred funds. All of these short-term investments were classified as available-for-sale securities. These auction rate securities were recorded at cost, which approximated fair market value due to their variable interest rates, which typically reset at the regular auctions every 7 to 35 days. Despite the long-term nature of their stated contractual maturities in fiscal year 2006, we liquidated these securities primarily through the auction process. As a result, we had no material cumulative gross unrealized holding gains (losses) or gross realized gains (losses) from short-term investments. All income generated from these short-term investments was recorded as interest income. As of December 29, 2007, $0.5 million of investments were included in other current assets. As of December 30, 2006, we did not have any short-term investments.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash and cash equivalents, restricted cash and receivables. Cash and cash equivalents and restricted cash are deposited with high credit quality financial institutions. The Company s receivables are derived from revenue earned from clients located primarily in the U.S. and are denominated in U.S. dollars. For the fiscal years ended 2007, 2006 and 2005, one client, United HealthCare Services, Inc., accounted for 24%, 20% and 13% of total revenue, respectively, in such years. At December 29, 2007 and December 30, 2006, the same client accounted for 27% and 31% of total net receivables, respectively.

Equipment and Leasehold Improvements

Computers, software, furniture and equipment are carried at cost and depreciated on a straight-line basis over their estimated useful lives. Leasehold improvements are amortized over the lesser of the useful life or the lease term. The useful life for computers and software is three years. For enterprise software applications where a longer useful life is deemed appropriate, five years is used. For furniture and equipment, a useful life of five years is used. Maintenance and repair costs are expensed as incurred. The cost and related accumulated depreciation of assets sold or disposed of are eliminated from the respective accounts and the resulting gain or loss is included in the statements of operations. The carrying value of equipment and leasehold improvements is periodically reviewed to assess recoverability based on future undiscounted cash flows. An impairment loss, if any, would be measured as the excess of the carrying value over the fair value.

The Company accounts for software developed for internal use in accordance with Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. As such, costs incurred that relate to the planning and post-implementation phases of development are expensed. Costs incurred during application development stage are capitalized and amortized over the asset s estimated useful life, generally three to five years.

The Company leases certain equipment using both capital leases and operating leases as prescribed under SFAS No. 13 Accounting for Leases. Assets leased under capital leases are recorded at the present value of future lease payments and depreciated on a straight line basis of three years. Prior to 2007, there were no assets acquired through capital leases.

eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Goodwill

Goodwill is tested annually for impairment in accordance with SFAS No. 142 Goodwill and Other Intangible Assets . The provisions of SFAS 142 require that a two-step test be performed to assess goodwill for impairment. In the first step, the fair value of each reporting unit is compared with its carrying value. If the fair value exceeds the carrying value, goodwill is not impaired and no further testing is performed. The second step is performed if the carrying value exceeds the fair value. The implied fair value of the reporting unit s goodwill must be determined and compared to the carrying value of the goodwill. If the carrying value of a reporting unit s goodwill exceeds its implied fair value, an impairment loss equal to the difference will be recorded.

There has been no impairment identified as a result of the annual review of goodwill as of December 29, 2007, December 30, 2006 and December 31, 2005. The carrying value of goodwill was $2.6 million as of December 29, 2007 and December 30, 2006.

Intangible Assets

Intangible assets reflect intangibles related to the 2004 Interelate Acquisition and the 2003 purchase of a license for certain intellectual property. These assets are amortized over 12 months to 60 months. The original cost of intangible assets as of December 29, 2007 and December 30, 2006 was $2.5 million and $2.3 million, respectively. Accumulated amortization of intangible assets as of December 29, 2007 and December 30, 2006 were $1.7 million and $1.3 million, respectively. In addition, for the fiscal years ended 2007 and 2006, the Company included $0.4 million and $0.2 million of cost related to patent applications as intangibles assets. Amortization expense of intangible assets will be $0.3 million and $0.2 million for fiscal years 2008 and 2009, respectively and rounds to zero thereafter.

Income Taxes

The Company uses an asset and liability approach, as required under SFAS No. 109, Accounting for Income Taxes, for financial accounting and reporting of income taxes. Deferred income taxes are provided when tax laws and financial accounting standards differ with respect to the amount of income for the year, the basis of assets and liabilities and for tax loss carryforwards. The Company does not provide U.S. deferred income taxes on earnings of U.S. or foreign subsidiaries, which are expected to be indefinitely reinvested.

Stockholders Equity

Stockholders equity includes common stock issued, additional paid-in capital, accumulated deficit, treasury stock and accumulated other comprehensive loss. The 3.7 million shares of Series B stock are not classified as permanent equity or a liability in the accompanying balance sheets. These shares of Series B stock are conditionally redeemable and do not meet the definition of a mandatorily redeemable financial instrument as defined in SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, as the preferred stockholders have the ability to initiate a redemption upon the occurrence of certain events that are considered outside the Company s control.

Foreign Currency Translation

The functional currencies for the Company s foreign subsidiaries are their local currencies. All assets and liabilities of foreign subsidiaries are translated to U.S. dollars at end of period exchange rates. The resulting translation adjustments are recorded as a component of stockholders equity and comprehensive income (loss). Income and expense items are translated at average exchange rates prevailing during the period. Gains and losses from foreign currency transactions of these subsidiaries are included in interest and other income (expense) within the consolidated statements of operations.

eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock-Based Compensation

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

Prior to January 1, 2006, we used the intrinsic value method to account for stock-based employee compensation under Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees, and therefore we did not recognize compensation expense in association with options granted at or above the market price of our common stock at the date of grant (see Note Fifteen Stock-Based Compensation).

New Accounting Standards

In February 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The company is required to adopt SFAS 159 beginning in fiscal year 2008. The company does not expect to elect the fair value option permitted under SFAS 159 so adoption will have no impact on its financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements , which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for fiscal years beginning after November 15, 2007. The Company intends to adopt SFAS 157 effective January 1, 2008 and does not expect the implementation to have a material effect on its consolidated financial statements.

In July 2006, the FASB issued Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109, Accounting for Income Taxes. The Interpretation addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on derecognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures.

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eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company adopted the provisions of FIN 48 on December 31, 2006. As a result of FIN 48 implementation, the Company recorded a $12.8 million decrease in the deferred tax assets associated with the net operating loss carryover, which is offset with a reduction to the valuation allowance with no net change to retained earnings. The Company had unrecognized tax benefits of $12.8 million as of December 31, 2006, the date of adoption.

In June 2006, the FASB ratified a consensus opinion reached by EITF on EITF Issue 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation). The guidance in EITF Issue 06-3 requires disclosure in interim and annual financial statements of the amount of taxes on a gross basis, if significant, that are assessed by a governmental authority that are imposed on and concurrent with a specific revenue producing transaction between a seller and customer such as sales, use, value added and some excise taxes. Additionally, the income statement presentation (gross or net) of such taxes is an accounting policy decision that must be disclosed. The consensus in EITF Issue 06-3 is effective for interim and annual reporting periods beginning after December 15, 2006. The Company adopted EITF Issue 06-3 effective December 31, 2006. The Company presents these taxes on a net basis. The adoption of EITF Issue 06-3 did not have a material effect on the financial statements.

Note Three Severance and Related Costs

To improve operating efficiencies the Company has established two business units aligned along our primary Service Lines, Behavioral Analytics and Integrated Contact Solutions. As part of the company s restructuring, key functions were reviewed and evaluated and 41 positions were eliminated in late 2007.

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

During fiscal years 2007, 2006 and 2005, the Company recognized pre-tax charges (including adjustments) of $1.3 million, $0.7 million and $0.4 million, respectively. The $1.3 million of expense recorded during 2007 is related to employee severance and related costs for the elimination of 41 positions. The $0.7 million of expense recorded during 2006 is primarily related to $0.8 million of employee severance and related costs for the elimination of twelve positions in the North American and International segments, offset by a favorable adjustment of $0.1 million related to previously estimated severance and facility cost accruals. The $0.4 million of severance and related costs for fiscal year 2005 included $0.6 million of employee severance and related costs for the elimination of nine positions in both the North American and International segments, offset by favorable adjustments of $0.2 million related to previously estimated severance cost and facility accruals.

During fiscal years 2007, 2006 and 2005, the Company made cash payments of $0.8 million, $1.1 million and $1.6 million related to cost reduction actions. Facility costs related to office space reductions and office closures, reserved for in fiscal years 2002 and 2001, were paid pursuant to contractual lease terms through 2007. The Company expects substantially all remaining severance and other related accruals to be paid out by the second quarter of 2008 pursuant to agreements entered into with affected employees.

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eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The severance and related costs and their utilization for the fiscal years ended 2005, 2006 and 2007 are as follows:

	Employee Severance	Facilities	Total
Balance, January 1, 2005	$ 0.7	$ 1.2	$ 1.9
Charges	0.6		0.6
Adjustments	(0.1)	(0.1)	(0.2)
Charged to severance and related costs	0.5	(0.1)	0.4
Payments	(1.2)	(0.4)	(1.6)
Balance, December 31, 2005		0.7	0.7
Charges	0.8		0.8
Adjustments		(0.1)	(0.1)
Charged to severance and related costs	0.8	(0.1)	0.7
Payments	(0.8)	(0.3)	(1.1)
Balance, December 30, 2006		0.3	0.3
Charges	1.3		1.3
Adjustments			
Charged to severance and related costs	1.3		1.3
Payments	(0.5)	(0.3)	(0.8)
Balance, December 29, 2007	$ 0.8	$	$ 0.8

As of December 29, 2007 a $0.8 million accrual remained on the balance sheet related to employee severance payments and is recorded in Accrued compensation and related costs.

Note Four Receivables, Net

Receivables consist of the following:

	As of	
	December 29, 2007	December 30, 2006
Amounts billed to clients	$ 9.6	$ 11.8
Unbilled revenue	1.8	1.1
	11.4	12.9

Allowances for doubtful accounts	(0.1)	(0.1)
Receivables, net	$ 11.3	$ 12.8

Amounts billed to clients represent fees and reimbursable project-related expenses. Unbilled revenue represents fees, project-related expenses, materials and subcontractor costs performed in advance of billings in accordance with contract terms. Unbilled revenue at December 29, 2007 and December 30, 2006 consists of amounts due from clients and is anticipated to be collected within normal terms. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our clients to make required payments and clients indicating their intention to dispute their obligation to pay for contractual services provided by us. If the financial condition of our clients were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note Five Current Prepaid Expenses

Current prepaid expenses were $8.5 million and $5.4 million as of December 29, 2007, and December 30, 2006, respectively. The increase is primarily prepaid 3rd party support costs related to our increased revenue in our Contact Center Managed Services and deferred costs related to our Behavioral Analytics Managed services. These costs are recognized over the contract terms of the respective agreements, generally one to five years. Costs included in current prepaid expenses will be recognized within the next twelve months. Current prepaid expenses consisted of the following:

	As of	
	December 29, 2007	December 30, 2006
Integrated Contact Solutions prepaid 3rd party support costs	$ 4.5	$ 2.6
Behavioral Analytics deferred costs	2.3	1.2
Other	1.7	1.6
Total	$ 8.5	$ 5.4

Note Six Equipment and Leasehold Improvements

Equipment and leasehold improvements consist of the following:

	As of	
	December 29, 2007	December 30, 2006
Computers and software	$ 30.7	$ 25.7
Furniture and equipment	2.1	2.0
Leasehold improvements	2.1	1.6
Equipment and leasehold improvements, gross	34.9	29.3
Accumulated depreciation and amortization	(27.5)	(24.5)
Equipment and leasehold improvements, net	$ 7.4	$ 4.8

Depreciation expense was $3.2 million, $2.1 million and $5.2 million for the fiscal years ended 2007, 2006 and 2005, respectively. During 2007, $1.5 million of assets were capitalized under capital leases. Depreciation of $0.1 million was taken on these assets in 2007. Prior to 2007, there were no fixed assets acquired under capital leases.

Note Seven Income Taxes

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109, Accounting for Income Taxes. The Interpretation addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position

should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on derecognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company adopted the provisions of FIN 48 on December 31, 2006. As a result of FIN 48 implementation, the Company recorded a $12.8 million decrease in the deferred tax assets associated with the net operating loss carryover, which is offset with a reduction to the valuation allowance with no net change to retained earnings. The Company had unrecognized tax benefits of $12.8 million as of December 31, 2006, the date of adoption.

A reconciliation of the gross amounts of unrecognized tax benefits at the beginning and end of the year are as follows:

Balance at December 31, 2006	$ 12.8
Additions based on tax positions related to the current year	
Additions for tax positions of prior years	
Reductions for tax positions of prior years	
Reductions for tax positions as a result of lapse of statute	
Settlements	
Balance at December 29, 2007	$ 12.8

Due to the Company's worldwide net operating loss carryover position, these unrecognized tax benefits will not impact the Company s effective tax rate, if recognized. Any change in the amount of unrecognized tax benefits within the next twelve months is not expected to result in a significant impact on the results of operations or the financial position of the Company.

Due to the Company's worldwide net operating loss carryover position, accrued interest and penalties associated with uncertain tax positions as of December 29, 2007 are not material. Interest and penalties associated with uncertain tax positions are recorded as part of income tax expense.

The Company is not currently under audit by the Internal Revenue Service (IRS). The statutes of limitation for the Company's income tax returns after 2001 remain open for examination by the IRS. In addition, the net operating loss carryforwards can be examined for a period of three years after filing the tax return for the year the loss is used. The Company has not been contacted by the IRS for examination for any of these years.

Foreign and U.S. state jurisdictions have statutes of limitations generally ranging from 3 to 5 years. The state impact of any federal changes remains subject to examination by various states for a period of up to one year after formal notification to the states. The Company Corporation and its subsidiaries may have various state and foreign income tax returns for immaterial jurisdictions in the process of examination throughout the reporting period.

(Loss) before income taxes consisted of the following:

	For the Fiscal Years Ended		
	2007	**2006**	**2005**
United States	$ (19.4)	$ (12.5)	$ (5.9)
Foreign	0.6	1.4	(1.7)
Total	$ (18.8)	$ (11.1)	$ (7.6)

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eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The income tax benefit (provision) consists of the following:

	For the Fiscal Years Ended		
	2007	**2006**	**2005**
Current:			
Federal	$	$	$
State	(0.1)		
Foreign	0.1		
Total current			
Deferred:			
Federal	(0.1)	(0.1)	
State	0.2		
Foreign			
Total deferred	0.1	(0.1)	
Income tax benefit (provision)	$ 0.1	$ (0.1)	$

Total income tax benefit (provision) differed from the amount computed by applying the federal statutory income tax rate due to the following:

	For the Fiscal Years Ended		
	2007	**2006**	**2005**
Federal tax benefit, at statutory rate	$ 6.5	$ 3.9	$ 2.7
State tax benefit, net of federal benefit	0.1		0.3
Foreign tax rate differences			0.1
Nondeductible expenses	(0.7)	(0.6)	(0.1)
Change in tax rates	(0.5)		
Adjustment to net operating losses	(1.1)		
Other	0.1	(0.2)	
Valuation allowance	(4.3)	(3.2)	(3.0)
Income tax benefit (provision)	$ 0.1	$ (0.1)	$

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eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Deferred tax assets and liabilities were comprised of the following:

	As of	
	December 29, 2007	**December 30, 2006**
Deferred tax assets:		
Net operating loss carryforwards	$ 47.5	$ 53.9
Receivable allowances	0.1	
Other accruals	1.9	1.6
Depreciation and amortization, including goodwill	2.5	2.7
Non-deductible reserves	0.2	0.2
Tax credit carry forwards	0.4	0.6
Valuation allowance	(48.8)	(56.6)
Total deferred tax assets	3.8	2.4
Deferred tax liabilities:		
Prepaid expenses	(3.8)	(2.5)
Total deferred tax liabilities	(3.8)	(2.5)
Net deferred tax asset (liability)	$	$ (0.1)

Deferred income taxes are not provided on certain undistributed earnings of foreign subsidiaries that are expected to be permanently reinvested in those companies. These earnings aggregate to an immaterial amount at December 29, 2007.

During fiscal year 2002, the Company established a valuation allowance related to deferred tax assets for the U.S. This is in addition to the valuation allowance established in 2001 for non-U.S. deferred tax assets. The Company continues to provide a valuation allowance on significantly all domestic and foreign deferred tax assets as the Company has determined that it is more likely than not that the deferred tax assets in these jurisdictions will not be realized. As of December 29, 2007, net deferred tax assets of $48.8 million without regard to deferred tax liabilities related to indefinite lived intangibles were fully offset by a valuation allowance. The Company s U.S. Federal NOLs (net operating losses) of $165.1 million and U.S. State NOLs of $103.1 million expire beginning in 2022 and 2008, respectively. The Company s non-U.S. NOLs of $12.2 million are subject to various expiration dates beginning in 2009. The Company also carries $0.6 million in Research and Development credit carryforwards that expire beginning in 2021.

The Company s ability to utilize its NOLs could become subject to significant limitations under Section 382 of the Internal Revenue Code if the Company were to undergo an ownership change. An ownership change would occur if the stockholders who own or have owned, directly or indirectly, 5% or more of the Company s common stock or are otherwise treated as 5% stockholders under Section 382 and the regulations promulgated thereunder increase their aggregate percentage ownership of the Company s stock by more than 50 percentage points over the lowest percentage of the stock owned by these stockholders at any time during the testing period, which is generally the three-year period preceding the potential ownership change. In the event of an ownership change, Section 382 imposes an annual limitation on the amount of taxable income a corporation may offset with NOL carryforwards. Any unused annual limitation may be carried over to later years until the applicable expiration date for the respective NOL carryforwards. The company has undergone a Section 382 analysis and does not believe there is a limitation on the use of NOL s under Section 382.

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eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company was spun off from TSC into a separate, publicly traded company on February 15, 2000. Pursuant to the Tax Sharing and Disaffiliation Agreement between TSC and the Company, TSC will generally be liable to the Company for any income tax benefits realized by TSC related to the exercise of the Company stock options by TSC employees. With respect to the realizability of these tax benefits, if any, the Company is dependent on TSC s ability to realize the benefits, and accordingly, the Company does not recognize these benefits until realized by TSC.

Note Eight Other Long-Term Assets

Other Long-term assets were $4.5 million and $3.9 million as of December 29, 2007, and December 30, 2006. Other long-term assets primarily consist of deferred costs related to our Behavioral Analytics Managed services and 3rd party support costs related to our Integrated Contact Solutions Managed services. These costs are recognized over the terms of the respective agreements, generally one to five years. Costs included in long-term assets will be recognized over the remaining term of the agreements beyond the first twelve months. Other Long-term assets consisted of the following:

	As of	
	December 29, 2007	December 30, 2006
Behavioral Analytics deferred costs	$ 2.0	$ 2.5
Integrated Contact Solutions prepaid 3rd party support costs	1.9	0.6
Other	0.6	0.8
Total	$ 4.5	$ 3.9

Note Nine Current Unearned Revenue

Current unearned revenue was $11.8 million and $7.4 million as of December 29, 2007, and December 30, 2006. The increase was primarily due to growth in Integrated Contact Solutions Managed services unearned revenue. Current unearned revenue reflects prepayment by our clients in advance of our recognition of this revenue. Payments are generally received in advance from clients that are utilizing our Behavioral Analytics Managed services and Integrated Contact Solutions Managed services. Current unearned revenue will be recognized within the next twelve months and consisted of the following:

	As of	
	December 29, 2007	December 30, 2006
Integrated Contact Solutions Managed Services	$ 8.5	$ 4.9
Behavioral Analytics Managed Services	2.2	1.7
Other	1.1	0.8
Total	$ 11.8	$ 7.4

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eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note Ten Other Current Liabilities

Other current liabilities consisted of the following:

	As of	
	December 29, 2007	**December 30, 2006**
Series B stock dividend payable	$ 0.7	$ 0.7
Income and other taxes	0.5	0.8
Other	2.6	2.9
Total	$ 3.8	$ 4.4

Note Eleven Long-Term Unearned Revenue

Long-term Unearned revenue was $7.4 million and $5.4 million as of December 29, 2007, and December 30, 2006. The increase reflects the pre-payment in 2007 of several multi-year agreements related to our Integrated Contact Solutions Managed services. Long-term unearned revenue reflects prepayment by our clients in advance of our recognition of this revenue. Payments are generally received in advance from clients that are utilizing our Behavioral Analytics Managed services and Integrated Contact Solutions Managed services. Long-term Unearned revenue reflects revenue that will be recognized beyond the next twelve months and consisted of the following:

	As of	
	December 29, 2007	**December 30, 2006**
Integrated Contact Solutions Managed Services	$ 3.7	$ 1.1
Behavioral Analytics Managed Services	3.2	3.3
Other	0.5	1.0
Total	$ 7.4	$ 5.4

Note Twelve Line of Credit

The Company maintains a Loan Agreement with LaSalle Bank National Association (the Bank) which was purchased by Bank of America in 2007. The maximum principal amount of the secured line of credit under the agreement (the Facility) increased to $5.0 million as of December 29, 2007 from $2.0 million as of December 30, 2006. The Facility requires the Company to maintain a minimum cash and cash equivalent balance within a secured account at the Bank. The balance in the secured account cannot be less than the outstanding balance drawn on the Facility line of credit, the letter of credit obligations under the Facility, plus a de minimis reserve to accommodate a Bank credit requirement associated with the purchase and transfer of foreign currencies and credit card payments. Available credit under the Facility has been reduced by $2.5 million related to letters of credit issued under the Facility to support our capital lease obligations and a Bank credit requirement associated with the purchase and transfer of foreign currencies and credit card payments. As a result, $2.5 million remains available under the Facility at December 29, 2007. Loans under the Facility bear interest at the Bank s prime rate or, at the Company s election, an alternate rate of LIBOR (London InterBank Offering Rate) plus 0.75%. We did not have any borrowings or interest expense under the Facility during fiscal years 2007 and 2006, respectively.

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eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note Thirteen Employee Benefit Plans

The Company U.S. employees are eligible to participate in the eLoyalty Corporation 401(k) Plan (the 401(k) Plan) on the first day of the month coinciding with or following their date of hire. The 401(k) Plan allows employees to contribute up to 20% of their eligible compensation and up to 100% of their bonus compensation, subject to Internal Revenue Service statutory limits. For fiscal years ended 2007, 2006 and 2005, a non-discretionary matching contribution was made at the rate of 50% of the amount that a Plan participant contributed to the Plan during the year, up to 6% of the participants qualifying compensation with a maximum match of 3% of eligible earnings. The Company recognized expenses related to the 401(k) Plan of $1.0 million, $0.8 million and $0.7 million for fiscal years ended 2007, 2006 and 2005, respectively. In addition, the Company funds non-U.S. contributory plans as required by statutory regulations. Amounts funded by the Company were immaterial for non-U.S. plans for the periods presented.

Note Fourteen Redeemable Convertible Preferred Stock and Capital Stock

The Company s authorized capital stock consists of (i) 50,000,000 shares of common stock, par value $0.01 per share, and (ii) 40,000,000 shares of preferred stock, par value $0.01 per share. The Company had 9,885,458 and 9,078,794 shares of its common stock issued as of December 29, 2007 and December 30, 2006, respectively and 9,735,492 and 9,078,794 outstanding as of December 29, 2007 and December 30, 2006, respectively. The Company has designated 5,000,000 shares of its preferred stock as its redeemable 7% Series B Convertible Preferred Stock (the Series B stock), of which 3,745,070 and 4,098,369 shares are issued and outstanding as of December 29, 2007 and December 30, 2006, respectively.

In December 2006, the Company completed an $18.0 million Rights Offering. Under terms of the Rights Offering, persons who owned shares of the Company s common stock or Series B Preferred Stock as of the close of business on November 20, 2006 (the record date for the Rights Offering) received the right to purchase 0.0910 shares of the Company s common stock. These subscription rights expired on December 15, 2006. Pursuant to the terms of the Rights Offering, the Company issued 1,001,342 shares of the Company common stock at $17.97 per share.

In December 2001, at the time of issuance of the Series B stock, a beneficial conversion adjustment was calculated (since the fair market value of a share of common stock at the time exceeded the purchase price of a share of Series B stock) aggregating $4.0 million. The Series B stock was recorded at the date of issuance net of issuance costs and the beneficial conversion adjustment. The discount attributable to the issuance costs was fully accreted on the date of issuance by charging additional paid-in capital and increasing the recorded amount of Series B stock. The Series B stock was accreted to its full redemption value of $23.3 million on a straight line basis from the date of issuance to June 19, 2002 by charging additional paid-in capital $0.7 million per month and increasing the recorded amount of Series B stock by a like amount.

The Series B stock accrues dividends at a rate of 7% per annum, is entitled to a preference upon liquidation and is convertible on a one-for-one basis into shares of our common stock, subject to adjustment for stock splits, stock dividends and similar actions. The Series B stock generally votes on a one-for-one basis with the common stockholders, subject to adjustment for certain actions and specified matters as to which the Series B stock is entitled to a separate class vote.

On March 17, 2000, the Board of Directors adopted a Stockholder Rights Plan (the Rights Plan). The Rights Plan is intended to assure fair and equal treatment for all of the Company s stockholders in the event of a hostile takeover attempt.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Under the terms of the Rights Plan, each share of the Company s common stock has associated with it ten rights (Rights). Each Right entitles the registered holder to purchase from the Company one one-hundredth of a share of Series A junior participating preferred stock, without par value, at an exercise price of $160 (subject to adjustment). The Rights become exercisable under certain circumstances: 10 days after the first public announcement that any person (an acquiring person) has acquired 15% or more of the Company s common stock or the announcement that any person has commenced a tender offer for 15% or more of the Company's common stock. On September 24, 2001, the Company amended the Rights Plan in connection with the private placement described above. The amendment provides, among other things, that (i) TCV and certain related parties shall not become an acquiring person for purposes of the Rights Plan so long as they do not own more than 35% of the Company s outstanding common stock (determined after giving effect to the conversion of the new Series B stock), and (ii) Sutter Hill and certain related parties shall not become an acquiring person for purposes of the Rights Plan so long as they do not own more than 20% of the Company s outstanding common stock (determined after giving effect to the conversion of the Series B stock). On December 27, 2007, the Company amended the Rights Plan to provide that Tench Coxe and various related entities affiliated with Sutter Hill Ventures will not become an acquiring person for purposes of the Rights Plan so long as they do not own more than 25% of the Company s outstanding common stock (determined after giving effect to the conversion of the held Series B stock).

In general, the Company may redeem the Rights in whole, but not in part, at a price of $0.01 per Right at any time until 10 days after any person has acquired 15% or more of the Company's common stock. The Rights will expire on March 17, 2010, unless earlier redeemed by the Company or exchanged for other shares of the Company's common stock.

Under specified conditions, each Right will entitle the holder to purchase the Company's common stock (or if the Company is acquired in a merger or other business combination, common stock of the acquiror) at the exercise price having a current market value of two times the exercise price. The terms of the Rights may be amended by the Company's Board of Directors.

Note Fifteen Stock-Based Compensation

Stock-Based Plans

The Company issues stock awards under two stock incentive plans: the eLoyalty Corporation 1999 Stock Incentive Plan (the 1999 Plan) and the eLoyalty Corporation 2000 Stock Incentive Plan (the 2000 Plan). Under the 1999 Plan and the 2000 Plan, awards of restricted stock or bonus (installment) stock, salary replacement, stock options, stock appreciation rights and performance shares may be granted to directors, officers, employees, consultants, independent contractors and agents of the Company and its subsidiaries. Awards granted under the 1999 Plan and 2000 Plan are made at the discretion of the Compensation Committee of the Company's Board of Directors. If shares or options awarded under the 1999 Plan and the 2000 Plan are not issued due to cancellation of unvested or unexercised options or shares, then those options or shares again become available for issuance under the plans. Under the 1999 Plan, on the first day of each fiscal year, beginning in 2000, the aggregate number of shares available for issuance under the 1999 Plan is automatically increased by an amount equal to 5% of the total number of shares of common stock that are outstanding. Under the 2000 Plan, the Company originally reserved 280,000 shares of the Company common stock for issuance. As of December 29, 2007, there were a total of 195,226 shares available for future grants under the 1999 Plan, 2000 Plan and from treasury stock.

Stock compensation expense was $10.6 million, $4.0 million and $2.6 million for the fiscal years ended 2007, 2006 and 2005, respectively. The Company recognized stock-based compensation under Statement of Financial Accounting Standards (SFAS) No. 123R Shared-Based Payment in 2007 and 2006. Prior to 2006, the Company recognized stock-based compensation under APB No. 25 Accounting for Stock Issued to

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Employees . The Company recognizes stock compensation expense on a straight-line basis over the vesting period. The Company has established its forfeiture rate based on historical experience. The Company did not recognize the windfall tax benefit related to the excess tax deduction because we currently do not anticipate realizing the tax savings associated with this deduction. The amount of this excess tax deduction for the fiscal years ended December 29, 2007 and December 30, 2006 was $4.1 million and $4.5 million, respectively.

Restricted Stock

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

Restricted and installment stock award activity was as follows for the years ended December 31, 2005, December 30, 2006 and December 29, 2007:

	Shares	Weighted Average Price
Nonvested balance at January 1, 2005	1,331,452	$ 5.73
Granted	406,500	$ 4.91
Vested	(465,727)	$ 5.86
Forfeited	(92,268)	$ 6.28
Nonvested balance at December 31, 2005	1,179,957	$ 5.35
Granted	761,100	$ 14.14
Vested	(525,221)	$ 6.64
Forfeited	(152,729)	$ 9.19
Nonvested balance at December 30, 2006	1,263,107	$ 9.69
Granted	433,024	$ 20.18
Vested	(533,258)	$ 11.45
Forfeited	(170,370)	$ 12.99
Nonvested balance at December 29, 2007	992,503	$ 12.80

	For the Fiscal Year Ended		
	2007	**2006**	**2005**
Total fair value of restricted and installment stock awards vested	$ 10.2	$ 8.0	$ 3.2

As of December 29, 2007, there remains $10.8 million of unrecognized compensation expense related to restricted and installment stock awards. These costs are expected to be recognized over a weighted average period of 3.1 years.

Stock Options

Stock option awards may be in the form of incentive or non-qualified options. Stock options are granted with an exercise price per share equal to the fair market value of a share of the Company common stock on the

eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

date of grant and have a maximum term of 10 years. The stock option terms are set by the Compensation Committee and generally become exercisable over a period of four years. The vesting can begin after a one or two-year period, with the balance of the shares vesting in equal monthly installments over the remainder of the four-year period, or the entire award can vest in equal monthly or quarterly increments over the vesting period. For the fiscal year ended 2007 and 2006, the Company recognized compensation expense related to option awards of $0.9 million and $0.2 million, respectively.

In addition, the 1999 Plan provides that each non-employee director, upon commencing service, shall receive a non-qualified stock option to purchase 5,000 shares of the Company common stock that vests ratably over a period of 48 months. The day after the annual stockholders meeting, each non-employee director is granted an additional non-qualified stock option to purchase 5,000 shares of the Company common stock that vest ratably over a period of 12 months. Stock options granted to non-employee directors have an exercise price per share equal to the fair market value of a share of the Company common stock on the grant date and are exercisable for up to 10 years.

During fiscal year 2007, a total of 270,000 options were granted. On February 20, 2007, 200,000 options were granted to four of the Company s executive officers, vesting in 16 equal quarterly installments, with a maximum term of 10 years. The exercise price per share was $21.95, the closing price of a share of the Company common stock on February 20, 2007. On May 17, 2007, the newly elected non-employee director was granted a non-qualified stock option to purchase 5,000 options of the Company common stock, vesting ratably over 48 months, with a maximum term of 10 years. The exercise price per share was $23.35, the closing price of a share of the Company common stock on May 17, 2007. On May 18, 2007, a total of 20,000 options were granted to non-employee directors with each of the four non-employee directors receiving 5,000 options, vesting ratably over 12 months, with a maximum term of 10 years. The exercise price per share was $23.38, the closing price of a share of the Company common stock on May 18, 2007. On November 15, 2007, a non-employee director was granted a non-qualified stock option to purchase 45,000 options of the Company common stock, vesting ratably over 48 months, with a maximum term of 10 years. The exercise price per share was $13.30, the closing price of a share of the Company common stock on November 15, 2007.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Option activity was as follows for the fiscal years ended 2005, 2006 and 2007:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Weighted Average Fair Value of Option Grants
Outstanding as of January 1, 2005	589,322	$ 29.71	7.0	
Exercisable as of January 1, 2005	464,576	$ 36.45		
Granted	4,800	$ 4.63		$ 3.52
Exercised		$		
Forfeited	(41,757)	$ 65.70		
Outstanding as of December 31, 2005	552,365	$ 26.78	6.1	
Exercisable as of December 31, 2005	477,782	$ 30.36		
Granted	4,800	$ 13.50		$ 8.92
Exercised	(11,963)	$ 14.26		
Forfeited	(31,333)	$ 66.01		
Outstanding as of December 30, 2006	513,869	$ 24.75	5.4	
Exercisable as of December 30, 2006	470,635	$ 26.63		
Outstanding intrinsic value at December 30, 2006	$ 3.3			
Exercisable intrinsic value at December 30, 2006	$ 2.7			
Granted	270,000	$ 20.64		$ 10.96
Exercised	(22,279)	$ 11.56		
Forfeited	(17,427)	$ 76.31		
Outstanding as of December 29, 2007	744,163	$ 22.45	6.2	
Exercisable as of December 29, 2007	534,788	$ 23.33		
Outstanding intrinsic value at December 29, 2007	$ 1.8			
Exercisable intrinsic value at December 29, 2007	$ 1.8			

For the Fiscal Years Ended

	2007	2006	2005
Total fair value of stock options vested	$ 0.9	$ 0.2	$ 0.2
Intrinsic value of stock options exercised	$ 0.1	$ 0.1	$
Proceeds received from option exercises	$ 0.3	$ 0.1	$

As of December 29, 2007, there remains $2.2 million of unrecognized compensation expense related to stock options. These costs are expected to be recognized over a weighted average period of 1.6 years.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The fair value of the options granted during fiscal years 2007, 2006 and 2005 was estimated on the date of grant using a Black Scholes option-pricing model. The Company used the following assumptions:

	For the Fiscal Years Ended		
	2007	**2006**	**2005**
Risk-free interest rates	4.5%	5.0%	3.4%
Expected dividend yield			
Expected volatility	57%	78%	101%
Expected lives	5.0 years	5.0 years	5.0 years

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

The following table illustrates the pro forma effect on net loss available to common stockholders and net loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation.

	For the Fiscal Year Ended 2005	
Net loss available to common stockholders as reported	$	(9.1)
Stock-based compensation related to restricted and installment awards included in net loss available to common stockholders		2.6
Stock-based compensation expense related to options, restricted and installment awards determined under the fair value method		(2.8)
Pro forma	$	(9.3)
Basic net loss per share:		
As reported	$	(1.43)
Pro forma	$	(1.47)
Diluted net loss per share:		
As reported	$	(1.43)
Pro forma	$	(1.47)

Salary Replacement Program

The Company implemented a Salary Replacement Program in November 2006. Under the initial program, executives and Vice Presidents exchange a percentage of their salary for grants of shares of the Company s common stock. The program began December 1, 2006 and had been authorized by the Board of Directors through December 31, 2007. In October 2007, the Board of Directors approved a modification and extended the plan with a new effective period until December 31, 2008. In addition, the program was expanded to include employees at the Senior Principal and Director levels who are based in North America. The salary reduction percentages range from 10% to 30% dependent on salary levels of the impacted executives, Vice Presidents, Senior Principals and Director levels. The percentage of salary paid in stock increased

for some of the more highly compensated executives and Vice Presidents. In February 2008, the Board of Directors modified the plan

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

to further reduce cash salaries at the Executive and Vice President level by 7.5% of gross salary in exchange for an additional 12.5% salary in the form of additional shares. Subject to quarterly Compensation Committee approval, the Company will issue common stock at fair market value commensurate with terms of the program. The plan was also modified to include payments of all directors fees, commissions, non-management bonuses and raises with stock in 2008. Under the Salary Replacement Program a total of 131,143 shares were issued during fiscal year 2007, and 18,087 shares were issued during fiscal year 2006.

Employee Stock Purchase Plan

During the first half of fiscal year 2007, the Company s Board of Directors and stockholders approved the proposal to increase the number of shares available under the Employee Stock Purchase Plan to 500,000. The Company reinstated the Plan in the second half of 2007. The Plan is intended to qualify as an employee stock purchase plan under section 423 of the Internal Revenue Code. Eligible employees are permitted to purchase shares of the Company common stock at below-market prices. Under this Plan, the first purchase period opened July 1, 2007 and ends on the last business day of each calendar quarter, and a total of 14,446 shares were issued during fiscal year 2007. We recorded $0.1 million of expense for this program in fiscal year 2007.

Note Sixteen Loss Per Share

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

	For the Fiscal Years Ended		
	2007	**2006**	**2005**
Net loss	$ (18.7)	$ (11.1)	$ (7.6)
Series B preferred stock dividends	(1.4)	(1.5)	(1.5)
Net loss available to common stockholders	$ (20.1)	$ (12.6)	$ (9.1)
Per common share			
Basic loss before Series B preferred stock dividends	$ (2.23)	$ (1.65)	$ (1.20)
Basic net loss	$ (2.40)	$ (1.86)	$ (1.43)

	For the Fiscal Years Ended		
(In thousands)	**2007**	**2006**	**2005**
Weighted average shares outstanding (basic and diluted)	8,399	6,769	6,359
Currently anti-dilutive common stock equivalents[1]	4,503	4,927	4,536

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

Note Seventeen Leases

Capital Leases

The Company acquired $1.5 million of computer equipment and leasehold improvements using capital leases in 2007. These assets were related to investments in our Behavioral Analytics Service Line and were placed in service in the fourth quarter of 2007. There was $0.1 million of depreciation expense in 2007 related to these assets. All capital leases are for a term of 3 years. The liabilities for these capital leases are included in Other current liabilities and Other long-term liabilities on the balance sheet.

eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following is a schedule by year of future minimum lease payments under capital leases together with the present value of the net minimum lease payments as of December 29, 2007:

Year	Amount
2008	$ 0.7
2009	0.7
2010	0.6
Thereafter	0.0
Total minimum lease payments	$ 2.0
Less: estimated executory costs	(0.3)
Net minimum lease payments	$ 1.7
Less: amount representing interest	(0.2)
Present value of minimum lease payments	$ 1.5

Operating Leases

The Company leases various office facilities under leases expiring at various dates through February 28, 2015. Additionally, the Company leases various property and office equipment under operating leases, generally under three year terms, expiring at various dates. Rental expense for all operating leases approximated $1.6 million, $1.4 million and $1.8 million for the fiscal years ended 2007, 2006 and 2005, respectively. These amounts exclude rental payments related to office space reductions, which were $0.3 million, $0.3 million and $0.4 million in fiscal years 2007, 2006 and 2005, respectively.

Future minimum rental commitments under non-cancelable operating leases with terms in excess of one year are as follows:

Year	Amount
2008	$ 1.9
2009	1.6
2010	0.9
2011	0.3
2012	0.3
Thereafter	0.8
Total minimum payments required	$ 5.8

Note Eighteen Litigation and Other Contingencies

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

The Company is a party to various agreements, including substantially all major services agreements and intellectual property licensing agreements, under which it may be obligated to indemnify the other party with

eLOYALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Under its By-Laws, subject to certain exceptions, the Company has agreed to indemnify its officers and directors for certain events or occurrences while the officer or director is, or was, serving at its request in such capacity or in certain related capacities. The Company has separate indemnification agreements with each of its directors and officers that requires it, subject to certain exceptions, to indemnify them to the fullest extent authorized or permitted by its By-Laws and the Delaware General Corporation Law. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a director and officer liability insurance policy that limits its exposure and enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal. The Company has no liabilities recorded for these agreements as of December 29, 2007.

Note Nineteen Segments

In 2007, eLoyalty engaged in business activities in one operating segment, which provides Consulting services, Managed services, and Product on both a fixed-price and a time and materials basis. The Company s services are delivered to clients in North America (U.S. and Canada), Europe and Australia. The Company s long-lived assets are predominately located in North America and consist of equipment, software, furniture and fixtures and leasehold improvements (net of accumulated depreciation). Prior to 2007, the Company had two reportable segments: North America (consisting of U.S. and Canada) and International. Net revenue for The Company s international operations (Europe and Australia) was $2.7 million, $4.1 million and $5.3 million for the fiscal years ended 2007, 2006 and 2005, respectively.

Beginning in 2008, the Company restructured into two business units and will begin to report results along these two segments in 2008.

Note Twenty Quarterly Data (Unaudited)

	For the Fiscal Year Ended 2007				
	1st	**2nd**	**3rd**	**4th**	**Year**
Total revenue	$ 27.9	$ 26.0	$ 26.6	$ 21.6	$ 102.1
Gross margin	$ 8.3(1)	$ 8.5(1)	$ 8.3(1)	$ 6.6(1)	$ 31.7(1)
Operating loss	$ (4.9)	$ (4.5)	$ (4.6)	$ (6.3)(2)	$ (20.3)(2)
Net loss	$ (4.6)	$ (3.9)	$ (4.3)	$ (5.9)(2)	$ (18.7)(2)
Net loss available to common stockholders	$ (4.9)	$ (4.3)	$ (4.7)	$ (6.2)(2)	$ (20.1)(2)
Basic net loss per share	$ (0.61)	$ (0.52)	$ (0.55)	$ (0.71)	$ (2.40)
Diluted net loss per share	$ (0.61)	$ (0.52)	$ (0.55)	$ (0.71)	$ (2.40)
Shares used to calculate basic and diluted net loss per share (in millions)	8.04	8.20	8.58	8.78	8.40

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	For the Fiscal Year Ended 2006[3]				
	1st	**2nd**	**3rd**	**4th**	**Year**
Total revenue	$ 19.6	$ 20.6	$ 25.9	$ 23.7	$ 89.8
Gross margin	$ 3.4	$ 1.6	$ 7.2	$ 4.6	$ 16.8
Operating loss	$ (3.5)[4]	$ (5.2)[4]	$ (0.2)[4]	$ (2.8)	$ (11.8)[4]
Net loss	$ (3.4)[4]	$ (5.1)[4]	$ [4]	$ (2.6)	$ (11.1)[4]
Net loss available to common stockholders	$ (3.8)[4]	$ (5.5)[4]	$ (0.4)[4]	$ (2.9)	$ (12.6)[4]
Basic net loss per share	$ (0.58)	$ (0.82)	$ (0.05)	$ (0.42)	$ (1.86)
Diluted net loss per share	$ (0.58)	$ (0.82)	$ (0.05)	$ (0.42)	$ (1.86)
Shares used to calculate basic and diluted net loss per share (in millions)	6.60	6.70	6.79	7.00	6.77

[1] In fiscal year 2007, the Company classified certain expenses which had been previously reported within Cost of services as Selling, general and administrative expense. The impact of the reclassification for the first, second, third and fourth quarters of 2007 and for fiscal year 2007 was $4.7 million, $4.8 million, $4.7 million, $4.1 million and $18.3 million, respectively.

[2] Includes $1.3 million related to severance and related costs for the fourth quarter of fiscal year 2007 associated with cost reduction plans.

[3] Includes $0.8 million of income related to a minimum purchase agreement that expired at the end of the first quarter of 2006.

[4] Includes $0.4 million, $(0.1) million and $0.4 million related to severance and related costs for the first, second, and third quarters of fiscal year 2006 associated with cost reduction plans.

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eLOYALTY CORPORATION

SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS

(In millions)

Description of Allowance and Reserves	Balance at Beginning of Period	Additions Charged to Costs and Expenses	Additions Charged to Other Accounts	Deductions	Balance at End of Period
Valuation allowance for doubtful accounts:					
Year ended December 29, 2007	$ 0.1				$ 0.1
Year ended December 30, 2006	$ 0.2	(0.1)			$ 0.1
Year ended December 31, 2005	$ 0.4	(0.2)[1]			$ 0.2
Valuation allowance for deferred tax assets:					
Year ended December 29, 2007	$ 56.6	5.1		(12.9)[2]	$ 48.8
Year ended December 30, 2006	$ 54.7	1.9			$ 56.6
Year ended December 31, 2005	$ 52.6	3.0		(0.9)[3]	$ 54.7

(1) Reflects recovery of previous reserved balance.

(2) As a result of FIN 48 implementation, the Company recorded a $12.8 million decrease in the deferred tax assets associated with the net operating loss carryover and a $0.1 million reversal of a valuation allowance relating primarily to state NOL s.

(3) The valuation allowance and deferred tax assets decreased $0.9 million in 2005 as a result of adjustments to the deferred tax accounts for the write-off of certain state net operating loss deferred tax assets, as well as revisions to the prior year deferred tax asset accounts and the related valuation allowance that were in offsetting amounts.

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Item 9. ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.***

Not applicable.

Item 9A. ***Controls and Procedures.***

(a) Evaluation of Disclosure Controls and Procedures

Based on their evaluation for the period covered by this Form 10-K, eLoyalty s Chief Executive Officer and Chief Financial Officer have concluded that, as of December 29, 2007, the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) are effective.

(b) Management s Annual Report on Internal Control over Financial Reporting

eLoyalty s management is responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Due to its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate due to changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company conducted its evaluation of the effectiveness of internal control over financial reporting using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control Integrated Framework*. Based on its evaluation, our management concluded that our internal control over financial reporting was effective as of the end of the period covered by this Form 10-K.

(c) Attestation Report of the Registered Public Accounting Firm

Grant Thornton LLP, an independent registered public accounting firm, has audited the Consolidated Financial Statements included in this Form 10-K and, as part of their audit, has issued its report, included herein, on the effectiveness of our internal control over financial reporting. See Report of Grant Thornton LLP Independent Registered Public Accounting Firm on page 36, which is incorporated herein by reference.

(d) Changes in Internal Control over Financial Reporting

There has been no change in eLoyalty s internal control over financial reporting that occurred during the fourth quarter of fiscal year 2007 that has materially affected, or is reasonably likely to materially affect, eLoyalty s internal control over financial reporting.

Item 9B. **O*ther Information.***

Not applicable.

PART III

Item 10. ***Directors and Executive Officers of the Registrant.***

For information about our executive officers, see Executive Officers of the Company included as Item 4A of Part I of this Form 10-K. For information about our corporate Directors see the captions Director Election and Security Ownership of Certain Beneficial Owners and Management Section 16(a) Beneficial Ownership

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Reporting Compliance in the Proxy Statement to be filed by the Company for its 2008 Annual Meeting of Stockholders is incorporated herein by reference in response to this item.

eLoyalty Corporation maintains a code of conduct, business principles and ethical behavior (the Code of Conduct) applicable to all of our directors, officers and other employees including our Chief Executive Officer and Senior Financial Management. This Code of Conduct addresses ethical conduct, SEC disclosure, legal compliance and other matters as contemplated by Section 406 of the Sarbanes-Oxley Act of 2002. A copy of the Code of Conduct was filed as Exhibit 14.1 to the 2003 Annual Report on Form 10-K and the Code of Conduct is on our internet website. We will make a copy of it available to any person, without charge, upon written request to eLoyalty Corporation, 150 Field Drive, Suite 250, Lake Forest, Illinois 60045, Attn: General Counsel. To the extent permitted by applicable rules of the NASDAQ Global Market, we intend to satisfy the disclosure requirement under Item 5.05 of Form 8-K regarding amendments to or waivers of the Code of Conduct for the Chief Executive Officer or Senior Financial Management by posting this information on our internet website.

Item 11. ***Executive Compensation.***

The information under Compensation Discussion and Analysis, Executive Compensation and Director Compensation, in the Proxy Statement to be filed by the Company for its 2008 Annual Meeting of Stockholders is incorporated herein by reference in response to this item.

Item 12. ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.***

The information under the heading Security Ownership of Certain Beneficial Owners and Management Beneficial Ownership Information in the Proxy Statement to be filed by the Company for its 2008 Annual Meeting of Stockholders is incorporated herein by reference in response to this item.

The following table shows, as of December 29, 2007, information regarding outstanding awards under all compensation plans of the Company (including individual compensation arrangements) under which equity securities of the Company may be delivered:

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights[1]	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance[1][2]
Equity compensation plans approved by security holders	731,801	$ 22.14	143,489[3]
Equity compensation plans not approved by security holders	12,362	$ 40.77	51,737
Total[4]	744,163	$ 22.45	195,226

(1) Reflects number of shares of the Company s common stock.

(2) All of the securities available for future issuance listed herein may be issued other than upon the exercise of an option, warrant or similar right. All of these shares are available for award in the form of restricted stock, bonus stock, performance shares or similar awards under the Company s applicable equity compensation plans.

(3) The Company s plan that has been approved by its stockholders is the 1999 Stock Incentive Plan. This plan includes an automatic increase feature whereby, as of the first day of each fiscal year, the number of shares available for awards, other than incentive stock options, automatically increases by an amount equal to five percent (5%) of the number of shares of common stock then outstanding.

(4) Does not include (i) shares of restricted common stock held by employees, of which 878,048 shares were issued and outstanding as of December 29, 2007, which are included in the amount of issued and outstanding shares or (ii) 114,455 shares of common stock issuable pursuant to installment stock awards granted to employees, which (subject to specified conditions) will be issued in the future in consideration of the employees services to the Company.

The plan described above as not having been approved by the Company s stockholders is the 2000 Stock Incentive Plan. This is a broadly based plan under which non-statutory stock options, restricted stock and bonus stock awards may be granted to officers, employees and certain consultants and independent contractors of the Company and its subsidiaries. This plan may be administered by one or more committees of the Board of Directors that the Board has designated to carry out actions under the plan on its behalf, which is currently the Compensation Committee. All awards made under this plan are discretionary. The committee or, if applicable, the Board determines which eligible persons will receive awards and also determines all terms and conditions (including form, amount and timing) of each award. The plan terminates September 23, 2011, which is ten years after the effective date of the last amendment and restatement of the plan, unless terminated earlier by the Board. Termination of the plan will not affect the terms or conditions of any award granted prior to termination.

Item 13. ***Certain Relationships and Related Transactions.***

The information under the heading Transactions with Related Persons in the Proxy Statement to be filed by eLoyalty for its 2008 Annual Meeting of Stockholders is incorporated herein by reference in response to this item.

Item 14. ***Principal Accounting Fees and Services.***

The information under the caption Ratification of Selection of Independent Public Accountants Principal Accounting Fees and Services in the Proxy Statement to be filed by the Company for its 2008 Annual Meeting of Stockholders is incorporated herein by reference in response to this item.

PART IV

Item 15. ***Exhibits and Financial Statement Schedules.***

(a) *Documents filed as part of this report:*

(1) Financial Statements.

The consolidated financial statements filed as part of this report are listed and indexed under Item 8 of this Form 10-K and such list is incorporated herein by reference.

(2) Financial Statement Schedule.

The financial statement schedule filed as part of this report is listed and indexed under Item 8 of this Form 10-K and is incorporated herein by reference. We have omitted financial statement schedules other than that listed under Item 8 because such schedules are not required or applicable.

(3) Exhibits.

The list of exhibits filed with or incorporated by reference into this report is contained in the Exhibit Index to this report on Page I-1, which is incorporated herein by reference.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized, on March 12, 2008.

eLOYALTY CORPORATION

By /s/ KELLY D. CONWAY
Kelly D. Conway
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report on Form 10-K has been signed below by the following persons on behalf of the registrant in the capacities indicated on this 12th day of March 2008.

Name	Capacity
/s/ KELLY D. CONWAY Kelly D. Conway	Director, President and Chief Executive Officer (Principal Executive Officer)
* Tench Coxe	Chairman of the Board and Director
* Henry J. Feinberg	Director
* John T. Kohler	Director
* Michael J. Murray	Director
* John C. Staley	Director
/s/ CHRISTOPHER B. MIN Christopher B. Min.	Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)

*By: /s/ CHRISTOPHER B. MIN
Christopher B. Min,
Attorney-in-Fact

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EXHIBIT INDEX

We are including as exhibits to this Annual Report on Form 10-K certain documents that we have previously filed with the Securities and Exchange Commission (SEC) as exhibits, and we are incorporating such documents as exhibits herein by reference from the respective filings identified in parentheses below. The management contracts and compensatory plans or arrangements required to be filed as exhibits to this Annual Report on Form 10-K pursuant to Item 14(c) are those listed below as Exhibits and noted by an asterisk.

Exhibit No.	Description of Exhibit
3.1	Certificate of Incorporation of eLoyalty, as amended (filed as Exhibit 3.1 to eLoyalty's Registration Statement on Form S-1 (Registration No. 333-94293) (the S-1)).
3.2	Certificate of Designation of Series A Junior Participating Preferred Stock of the Company (included as Exhibit 4.2 to Amendment No.1 to eLoyalty's Registration Statement on Form 8-A (File No. 0-27975) filed with the SEC on March 24, 2000 (the 8-A Amendment)).
3.3	Certificate of Amendment to eLoyalty s Certificate of Incorporation December 19, 2001 (filed as Exhibit 3.3 to eLoyalty s Annual Report on Form 10-K for the year ended December 29, 2001).
3.4	Certificate of Amendment to eLoyalty s Certificate of Incorporation December 19, 2001 (filed as Exhibit 3.4 to eLoyalty s Annual Report on Form 10-K for the year ended December 29, 2001).
3.5	Certificate of Increase of Series A Junior Participating Preferred Stock of eLoyalty, filed December 19, 2001 (filed as Exhibit 3.5 to eLoyalty s Annual Report on Form 10-K for the year ended December 29, 2001).
3.6	Certificate of Designation of 7% Series B Convertible Preferred Stock of eLoyalty, filed December 19, 2001 (filed as Exhibit 3.6 to eLoyalty s Annual Report on Form 10-K for the year ended December 29, 2001).
3.7	By-Laws of eLoyalty (filed as Exhibit 3.2 to the S-1).
3.8	Amendment to By-Laws of eLoyalty Corporation, (filed on November 16, 2007 as Exhibit 3.1 to eLoyalty s Current Report on Form 8-K).
4.1	Rights Agreement, dated as of March 17, 2000, between eLoyalty and ChaseMellon Shareholder Services, L.L.C., as Rights Agent (filed as Exhibit 4.1 to the 8-A Amendment).
4.2	Amendment, dated as of September 24, 2001, to the Rights Agreement between eLoyalty and Mellon Investor Services LLC (filed as Exhibit 4.2 to eLoyalty s Current Report on Form 8-K dated September 24, 2001, File No. 0-27975).
4.3	Second Amendment to Rights Agreement, dated as of December 26, 2007, by and between eLoyalty and Mellon Investor Services LLC (filed as Exhibit 4.1 to eLoyalty s Current Report on Form 8-K filed with the SEC on December 27, 2007).
4.4	Certificate of Adjustment dated January 10, 2002 (filed as Exhibit 4.3 to eLoyalty s Annual Report on Form 10-K for the year ended December 29, 2001).
10.1	Form of Tax Sharing and Disaffiliation Agreement between Technology Solutions Company (TSC) and eLoyalty (filed as Exhibit 10.6 to the S-1).
10.2	Amended and Restated Investor Rights Agreement, dated as of December 19, 2001, by and among eLoyalty and the stockholders named therein (filed as Exhibit 10.3 to eLoyalty's Annual Report on Form 10-K for the year ended December 29, 2001).
10.3*	eLoyalty Corporation 2000 Stock Incentive Plan (as Amended and Restated as of September 24, 2001) (filed as Exhibit (d)(2) to eLoyalty's Tender Offer Statement on Schedule TO filed October 15, 2001).
10.4*	eLoyalty Corporation 1999 Stock Incentive Plan (as Amended and Restated as of May 16, 2002) (filed as Exhibit 10.3 to eLoyalty s Quarterly Report on Form 10-Q for the quarter ended June 29, 2002).

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Exhibit No.	Description of Exhibit
10.5*	Summary of eLoyalty Corporation s Vice President Compensation Program, as amended, May 11, 2005. (filed as Exhibit 99.1 to eLoyalty s Quarterly Report on Form 10-Q for the quarter ended April 2, 2005).
10.6*	eLoyalty Corporation 2006/2007 Salary Replacement Program (as Amended and Restated as of February 13, 2008) (filed as Exhibit 99.1 to eLoyalty s Current Report on Form 8-K filed February 19, 2008.)
10.7*	Form of Restricted Stock Award Agreement between applicable participant and eLoyalty (filed as Exhibit 10.23 to eLoyalty s Annual Report on Form 10-K for the year ended January 1, 2005).
10.8*	Form of Installment Stock Award Agreement between applicable participant and eLoyalty (filed as Exhibit 10.24 to eLoyalty s Annual Report on Form 10-K for the year ended January 1, 2005).
10.9*	Form of Option Award Agreement between applicable participant and eLoyalty (filed as Exhibit 10.8 to eLoyalty s Annual Report on Form 10-K for the year ended December 30, 2006).
10.10	Loan Agreement, dated as of December 17, 2001, between eLoyalty Corporation and LaSalle Bank National Association, together with Amendment No. 1 to Loan Agreement, dated as of February 27, 2002 (filed as Exhibit 10.27 to eLoyalty s Annual Report on Form 10-K for the year ended December 29, 2001).
10.11	Amendment No. 2 to Loan Agreement, dated as of March 18, 2002, between LaSalle Bank National Association and eLoyalty Corporation (filed as Exhibit 10.1 to eLoyalty s Quarterly Report on Form 10-Q for the quarter ended March 30, 2002).
10.12	Amendment No. 3 to Loan Agreement, dated as of May 13, 2002, between LaSalle Bank National Association and eLoyalty Corporation (filed as Exhibit 10.1 to eLoyalty s Quarterly Report on Form 10-Q for the quarter ended June 29, 2002).
10.13	Amendment No. 4 to Loan Agreement, dated as of December 9, 2002, between LaSalle Bank National Association and eLoyalty Corporation (filed as Exhibit 10.22 to eLoyalty s Annual Report on Form 10-K for the year ended December 28, 2002).
10.14	Amendment No. 5 to Loan Agreement, dated as of May 14, 2003, between LaSalle Bank National Association and eLoyalty Corporation (filed as Exhibit 10.1 to eLoyalty s Quarterly Report on Form 10-Q for the quarter ended June 28, 2003).
10.15	Amendment No. 6 to Loan Agreement, dated as of September 8, 2003, between LaSalle Bank National Association and eLoyalty Corporation (filed as Exhibit 10.1 to eLoyalty s Quarterly Report on Form 10-Q for the quarter ended September 27, 2003).
10.16	Amendment No. 7 to Loan Agreement, dated as of December 23, 2003, between LaSalle Bank National Association and eLoyalty Corporation (filed as Exhibit 10.19 to eLoyalty s Annual Report on Form 10-K for the year ended December 27, 2003).
10.17	Amendment No. 8 to Loan Agreement, dated as of December 21, 2004, between LaSalle Bank National Association and eLoyalty Corporation (filed as Exhibit 10.16 to eLoyalty s Annual Report on Form 10-K for the year ended January 1, 2005).
10.18	Amendment No. 9 to Loan Agreement, dated as of December 2, 2005, between LaSalle Bank National Association and eLoyalty Corporation (filed as Exhibit 10.16 to eLoyalty s Annual Report on Form 10-K for the year ended December 31, 2005).
10.19	Amendment No. 10 to Loan Agreement, dated as of December 22, 2005, between LaSalle Bank National Association and eLoyalty Corporation (filed as Exhibit 10.17 to eLoyalty s Annual Report on Form 10-K for the year ended December 31, 2005).
10.20	Amendment No. 11 to Loan Agreement, dated as of September 18, 2006, between LaSalle Bank National Association and eLoyalty Corporation (filed as Exhibit 10.1 to eLoyalty s Quarterly Report on Form 10-Q for the quarter ended September 30, 2006).

Exhibit No.	Description of Exhibit
10.21	Amendment No. 12 to Loan Agreement, dated as of December 21, 2006, between LaSalle Bank National Association and eLoyalty Corporation (filed as Exhibit 10.20 to eLoyalty s Annual Report on Form 10-K for the year ended December 30, 2006).
10.22+	Amendment No. 13 to Loan Agreement, dated as of December 6, 2007, between LaSalle Bank National Association and eLoyalty Corporation.
10.23*	Form of Indemnification Agreement entered into between eLoyalty Corporation and each of Tench Coxe and Jay C. Hoag (filed as Exhibit 10.15 to the S-1).
10.24*+	Indemnification Agreement, dated March 6, 2008, between eLoyalty Corporation and Henry J. Feinberg.
10.25*+	Amended and Restated Employment Agreement, dated December 28, 2007, between Kelly D. Conway and eLoyalty Corporation.
10.26*+	First Amendment to Amended and Restated Employment Agreement, dated February 26, 2008, between Kelly D. Conway and eLoyalty Corporation.
10.27*+	Indemnification Agreement, dated February 26, 2008, between Kelly D. Conway and eLoyalty.
10.28*	Employment Agreement, effective June 1, 2001, between Steven C. Pollema and eLoyalty (filed as Exhibit 10.1 to eLoyalty s Quarterly Report on Form 10-Q for the quarter ended June 30, 2001, File No. 0-27975).
10.29*	Indemnification Agreement, dated June 11, 2001, between Steven C. Pollema and eLoyalty (filed as Exhibit 10.3 to eLoyalty s Quarterly Report on Form 10-Q for the quarter ended June 30, 2001, File No. 0-27975).
10.30*	Amended Employment Agreement, dated January 8, 2007, between Karen Bolton and eLoyalty (filed as Exhibit 10.26 to eLoyalty s Annual Report on Form 10-K for the year ended December 30, 2006).
10.31*	Employment Agreement, dated December 17, 2004, between Christopher Danson and eLoyalty (filed as Exhibit 10.25 to eLoyalty s Annual Report on Form 10-K for the year ended January 1, 2005).
10.32*	Indemnification Agreement, effective as of December 17, 2004, between Christopher Danson and eLoyalty (filed as Exhibit 10.26 to eLoyalty s Annual Report on Form 10-K for the year ended January 1, 2005).
10.33*+	Amended and Restated Employment Agreement, dated February 26, 2008, between Steven H. Shapiro and eLoyalty.
10.34*+	Indemnification Agreement, effective as of February 26, 2008, between Steven H. Shapiro and eLoyalty.
10.35*	Employment Agreement, dated February 14, 2008, between Christopher B. Min and eLoyalty (filed as exhibit 10.1 to eLoyalty s Current Report on Form 8-K filed with the SEC on February 15, 2008.
10.36*	Indemnification Agreement, effective as of February 14, 2008, between Christopher B. Min and eLoyalty (filed as exhibit 10.2 to eLoyalty s Current Report on Form 8-K filed with the SEC on February 15, 2008.
10.37*+	Summary of Director Compensation.
10.38*+	Summary of 2008 Named Executive Officer Compensation.
21.1+	Subsidiaries of eLoyalty Corporation.
23.1+	Consent of Grant Thornton LLP.
23.2+	Consent of PricewaterhouseCoopers LLP.
24.1+	Power of Attorney from Tench Coxe, Director.

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Exhibit No.	Description of Exhibit
24.2+	Power of Attorney from Henry J. Feinberg, Director.
24.3+	Power of Attorney from John T. Kohler, Director.
24.4+	Power of Attorney from Michael J. Murray, Director.
24.5+	Power of Attorney from John C. Staley, Director.
31.1+	Certification of Kelly D. Conway under Section 302 of the Sarbanes-Oxley Act of 2002.
31.2+	Certification of Christopher B. Min under Section 302 of the Sarbanes-Oxley Act of 2002.
32.1+	Certification of Kelly D. Conway and Christopher B. Min under Section 906 of the Sarbanes-Oxley Act of 2002.

+ Filed herewith.

* Represents a management contract or compensatory plan or arrangement.

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