

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended August 31, 2009**

OR

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

**Commission file number 001-15503**

**WORKSTREAM INC.**

(Exact name of registrant as specified in its charter)

**Canada**

(State or other jurisdiction of  
incorporation or organization)

**N/A**

(IRS Employer Identification No.)

**485 N. Keller Road, Suite 500  
Maitland, Florida**

(Address of principal executive offices)

**32751**

(Zip Code)

Registrant's telephone number, including area code:

**(407) 475-5500**

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

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

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

Yes  No

As of October 13, 2009, there were 56,993,312 common shares, no par value, outstanding, excluding 108,304 common shares held in escrow.

# WORKSTREAM INC.

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**WORKSTREAM INC.**  
**CONSOLIDATED BALANCE SHEETS**

	Notes	August 31, 2009	May 31, 2009
	2	(Unaudited)	
<b>ASSETS:</b>			
Current assets:			
Cash and cash equivalents		\$ 1,068,224	\$ 1,643,768
Accounts receivable, net	3	2,421,743	2,746,360
Prepaid expenses and other assets		148,851	146,609
Total current assets		3,638,818	4,536,737
Equipment, net		753,005	757,050
Other assets		30,990	30,990
Acquired intangible assets, net		-	21,500
Goodwill		17,729,448	17,729,448
TOTAL ASSETS		\$ 22,152,261	\$ 23,075,725
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT:</b>			
Current liabilities:			
Accounts payable		\$ 1,891,633	\$ 1,856,892
Accrued liabilities		2,901,781	2,924,145
Accrued compensation		382,647	526,935
Senior secured notes payable and accrued interest	1, 4	20,667,195	20,158,044
Embedded put derivative	4	521,026	493,693
Current portion of long-term obligations		205,424	199,516
Deferred revenue		1,936,782	2,591,328
Total current liabilities		28,506,488	28,750,553
Long-term obligations less current portion		242,347	124,594
Deferred revenue – long term		1,091	-
Common stock warrant liability	1	425,600	-
Total liabilities		29,175,526	28,875,147
Commitments and Contingencies	5		
<b>STOCKHOLDERS' DEFICIT:</b>			
Preferred stock, no par value	6	-	-
Common stock, no par value		113,668,376	113,668,376
Additional paid-in capital		17,965,944	18,269,589
Accumulated other comprehensive loss		(883,790)	(861,074)
Accumulated deficit		(137,773,795)	(136,876,313)
Total stockholders' deficit	1	(7,023,265)	(5,799,422)
TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT		\$ 22,152,261	\$ 23,075,725

See accompanying notes to these consolidated financial statements.

**WORKSTREAM INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS**  
(Unaudited)

	<u>Notes</u>	<u>Three Months Ended</u>	
		<u>August 31, 2009</u>	<u>August 31, 2008</u>
Revenues:			
Software		\$ 1,502,211	\$ 1,791,457
Professional services		234,338	721,971
Rewards		1,527,930	1,518,915
Career networks		947,266	1,520,544
Revenues, net		<u>4,211,745</u>	<u>5,552,887</u>
Cost of revenues		<u>1,289,688</u>	<u>1,602,470</u>
Gross profit		<u>2,922,057</u>	<u>3,950,417</u>
Operating expenses:			
Selling and marketing		456,668	1,302,607
General and administrative		2,021,856	2,925,486
Research and development		429,139	1,302,102
Amortization and depreciation		281,777	480,774
Total operating expenses		<u>3,189,440</u>	<u>6,010,969</u>
Operating loss		<u>(267,383)</u>	<u>(2,060,552)</u>
Other income (expense):			
Interest income and expense, net		(514,075)	3,590
Change in fair value of warrants and derivative	<b>4</b>	423,467	-
Other income and expense, net		(1,602)	38,859
Other income (expense)		<u>(92,210)</u>	<u>42,449</u>
Loss before income tax expense		(359,593)	(2,018,103)
Income tax expense		<u>(289)</u>	<u>(33,479)</u>
NET LOSS		<u>\$ (359,882)</u>	<u>\$ (2,051,582)</u>
Basic and diluted loss per share	<b>8</b>	<u>\$ (0.01)</u>	<u>\$ (0.04)</u>
Net loss		\$ (359,882)	\$ (2,051,582)
Comprehensive loss:			
Foreign currency translation adjustments		<u>(22,716)</u>	<u>3,912</u>
COMPREHENSIVE LOSS		<u>\$ (382,598)</u>	<u>\$ (2,047,670)</u>

See accompanying notes to these consolidated financial statements.

**WORKSTREAM INC.**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIT**  
**(Unaudited)**

	<b>Common Stock</b>		<b>Additional Paid-In Capital</b>	<b>Accumulated Other Comprehensive Loss</b>	<b>Accumulated Deficit</b>	<b>Total Stockholders' Deficit</b>	<b>Comprehensive Loss</b>
	<b>Shares</b>	<b>Amount</b>					
Balance at May 31, 2009	56,993,312	\$ 113,668,376	\$ 18,269,589	\$ (861,074)	\$ (136,876,313)	\$ (5,799,422)	
Restricted stock unit grants and expense	-	-	14,938	-	-	14,938	
Stock option expense	-	-	20,217	-	-	20,217	
Cumulative effect of change in accounting principle for warrant classification	-	-	(338,800)	-	(537,600)	(876,400)	
Net loss	-	-	-	-	(359,882)	(359,882)	\$ (359,882)
Cumulative translation adjustment	-	-	-	(22,716)	-	(22,716)	(22,716)
Comprehensive loss	-	-	-	-	-	-	\$ (382,598)
Balance at August 31, 2009	56,993,312	\$ 113,668,376	\$ 17,965,944	\$ (883,790)	\$ (137,773,795)	\$ (7,023,265)	

See accompanying notes to these consolidated financial statements.

**WORKSTREAM INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)

	<b>Three Months Ended</b>	
	<b>August 31, 2009</b>	<b>August 31, 2008</b>
Cash flows provided by (used in) operating activities:		
Net loss	\$ (359,882)	\$ (2,051,582)
Adjustments to reconcile net loss to net cash used in operating activities:		
Amortization and depreciation	281,777	480,774
Leasehold inducement amortization	6,270	(13,582)
Provision for bad debt	152,034	168,608
Stock related compensation	35,155	93,687
Change in fair value of warrants and derivative	(423,467)	-
Net change in components of working capital:		
Accounts receivable	172,583	(327,661)
Prepaid expenses and other assets	(2,242)	154,231
Accounts payable	122,689	(247,135)
Accrued liabilities	486,787	459,674
Accrued compensation	(144,288)	(394,542)
Deferred revenue	(653,455)	(238,660)
Net cash used in operating activities	<u>(326,039)</u>	<u>(1,916,188)</u>
Cash flows provided by (used in) investing activities:		
Purchase of equipment	(99,385)	(8,641)
Decrease in restricted cash	-	(34,385)
Proceeds from short-term investments	-	9,091
Net cash provided by (used in) investing activities	<u>(99,385)</u>	<u>(33,935)</u>
Cash flows provided by (used in) financing activities:		
Repayment of long-term obligations	(128,566)	(78,979)
Net cash provided by (used in) financing activities	<u>(128,566)</u>	<u>(78,979)</u>
Effect of exchange rate changes on cash and cash equivalents	<u>(21,554)</u>	<u>(96,284)</u>
Net increase (decrease) in cash and cash equivalents	(575,544)	(2,125,386)
Cash and cash equivalents, beginning of period	1,643,768	3,435,337
Cash and cash equivalents, end of period	<u>\$ 1,068,224</u>	<u>\$ 1,309,951</u>
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	\$ 7,774	\$ 15,009
Taxes	<u>\$ 7,225</u>	<u>\$ -</u>
Supplemental schedule of non-cash investing and financing activities:		
Equipment acquired under capital leases	<u>\$ 160,042</u>	<u>\$ -</u>
Cumulative effect of change in accounting principle for warrant classification	<u>\$ 876,400</u>	<u>\$ -</u>
Exchange of warrant liability for senior secured notes payable	<u>\$ -</u>	<u>\$ 19,000,000</u>

See accompanying notes to these consolidated financial statements.

**WORKSTREAM INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**NOTE 1. THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Unaudited Interim Financial Information**

The accompanying consolidated balance sheet as of August 31, 2009, the consolidated statements of operations and comprehensive loss for the three months ended August 31, 2009 and 2008, and the consolidated statements of cash flows for the three months ended August 31, 2009 and 2008 are unaudited but include all adjustments (consisting of normal recurring adjustments) that are, in the opinion of management, necessary for a fair presentation of our financial position at such dates and our results of operations and cash flows for the periods then ended, in conformity with accounting principles generally accepted in the United States (“GAAP”). The consolidated balance sheet as of May 31, 2009 has been derived from the audited consolidated financial statements at that date but, in accordance with the rules and regulations of the United States Securities and Exchange Commission (“SEC”), does not include all of the information and notes required by GAAP for complete financial statements. Operating results for the three months ended August 31, 2009 are not necessarily indicative of results that may be expected for the entire fiscal year. The consolidated financial statements should be read in conjunction with the consolidated financial statements and notes for the fiscal year ended May 31, 2009 included in the Company’s Form 10-K filed with the SEC on September 14, 2009.

**Description of the Company**

Workstream Inc. (“Workstream” or the “Company”), is a provider of services and software for Human Capital Management (“HCM”). HCM is the process by which companies recruit, train, evaluate, motivate and retain their employees. Workstream offers software and services that address the needs of companies to more effectively manage their human capital management function. Workstream has two distinct reportable segments: Enterprise Workforce Services and Career Networks. The Enterprise Workforce Services segment offers a suite of HCM software solutions, which includes performance management, compensation management, development, recruitment, benefits administration and enrollment, succession planning, and employee reward programs. The Career Networks segment offers recruitment research, resume management and career transition services. In addition, Career Networks provides services through a web-site where job-seeking senior executives can search job databases and post their resumes, and companies and recruiters can post position openings and search for qualified senior executive candidates. Workstream conducts its business primarily in the United States and Canada.

**Going Concern and Management’s Assessment of Liquidity**

The opinion of our independent registered public accounting firm on the audited financial statements as of and for the year ended May 31, 2009 contained an explanatory paragraph regarding substantial doubt about our ability to continue as a going concern.

The Company has incurred substantial losses in recent years and months and, as a result, has a stockholders deficit of \$7,023,265 as of August 31, 2009. Losses for the three months ended August 31, 2009 were \$359,882 and losses for the years ended May 31, 2009 and 2008 were \$4,856,356 and \$52,616,875, respectively. The Company's ability to continue as a going concern depends, primarily, upon its ability to successfully refinance approximately \$20.7 million of its senior secured notes payable (the “Notes”), including accrued interest thereon that went into default on May 22, 2009 due to the Company’s suspension of trading on the NASDAQ Stock Market as a result of its stockholders deficit. Our ability to continue as a going concern is also dependent upon our ability to generate positive cash flows from operations. The accompanying financial statements have been prepared on a going concern basis, which assumes continuity of operations and realization of assets and liabilities in the ordinary course of business. The financial statements do not include any adjustments that might result if the Company was forced to discontinue its operations.

In August 2009, the Company signed a term sheet with the holders of the Notes (“Holders”), whereby the Holders agreed to restructure the Notes. The term sheet provides that the Holders would exchange the Notes and the accrued interest thereon (approximately \$20.7 million as of August 31, 2009) into \$9.5 million of new senior secured notes with the balance as convertible notes. The proposed new notes would accrue interest at a rate of 9.5% per annum and have a maturity date of

July 31, 2012. The Company and the Holders are negotiating the final terms of the refinancing documents and expect to close the transaction during the Company's second fiscal quarter ending November 30, 2009.

There can be no assurance that the Company will be successful in its negotiations with the existing Holders and other parties or that the terms of any such refinancing or conversions will not result in the issuance, or potential issuance, of a significant amount of equity securities that will cause substantial dilution to the Company's stockholders. If the Company is not successful in refinancing the Notes or in otherwise entering into a financing, sale, or business transaction that infuses sufficient cash resources into the Company in the near future, any collection actions by the Holders could have a material adverse affect on the liquidity and financial condition of the Company and its ability to secure additional financing and continue as a going concern.

Due to significant reductions in operating expenses in the fourth quarter of fiscal 2008 and throughout fiscal 2009, management believes the current liquidity will be sufficient to meet its anticipated working capital and capital expenditure requirements upon the refinancing of the Notes. The current operating loss is the result of current economic conditions and is a reflection of the overall health of the economy as a whole. As it relates to the Career Networks segment of the business, management believes that the career transition services will gain strength with new programs implemented at the end of the first quarter of fiscal 2010. Based on an analysis of our current contracts, forecasted new business, our current backlog and current expense level, management believes the Company will meet its cash flow needs for fiscal 2010 assuming the successful refinancing of the Notes. If these measures fall short, management will consider additional cost savings measures, including cutting back product development initiatives, further reducing general and administrative expenses and reducing sales and marketing expenditures. We recognize that there are no assurances that the Company will be successful in meeting its cash flow requirements, however, management is confident that, if necessary, there are other alternatives available to fund operations and meet cash requirements during fiscal 2010.

#### **Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions affecting the amounts reported in the consolidated financial statements and the accompanying notes. Changes in these estimates and assumptions may have a material impact on the financial statements and accompanying notes.

Significant estimates and assumptions made by management include the assessment of goodwill impairment. When assessing goodwill for possible impairment, significant estimates include future cash flow projections, future revenue growth rates, the appropriate discount rate reflecting the risk inherent in future cash flows, the interpretation of current economic indicators and market valuations and our strategic plans with regard to our operations. It is reasonably possible that those estimates may change in the near-term and may materially affect future assessments of goodwill impairment. Other significant estimates include the provision for doubtful accounts, valuing derivative instruments, valuing compensation related to stock-based transactions, and estimating future taxable income and the probability that net operating loss carry-forwards will be utilized.

#### **Principles of Consolidation**

The consolidated financial statements include the accounts of Workstream Inc. and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

#### **Allowance for Doubtful Accounts**

We perform ongoing credit evaluations of our accounts receivable balances. Based on historical experience, we evaluate the accounts for potential uncollectible amounts based on a specific identification methodology and record a general reserve for all remaining balances. Based on the age of the receivable, cash collection history and past dilution in the receivables, we make an estimate of our anticipated bad debt. We believe our estimates are reasonable, but there can be no assurance that our estimates will not change given a change in economic conditions or business conditions within our industry, our individual customer base or our Company. Any adjustments to this account are reflected in the accompanying statements of operations and comprehensive loss as a general and administrative expense.

## Goodwill

We test goodwill for impairment on an annual basis or as needed if circumstances arise that reduce the value of our reporting units below the carrying value. We compare the fair value of each reporting unit to its carrying amount (including goodwill) for our impairment evaluation. Our business segments are considered reporting units for goodwill impairment testing. Goodwill is considered to be impaired if the carrying value of a reporting unit exceeds its fair value. If goodwill is considered to be impaired, the loss that is recognized is equal to the amount that the reporting units' carrying value of goodwill exceeds the implied fair value of that goodwill.

There are judgments and estimates built into our fair value analysis, including future cash flow projections, the discount rate representing innate risk in future cash flows, market valuation, strategic operation plans and our interpretation of current economic indicators. Changes in any of the underlying assumptions will cause a change in the results, which could cause the fair value of one or more of the reporting units to be worth less than the current carrying amounts. In addition to a change in market and economic conditions or our strategic plans, the possibility exists that our conclusions could change which would result in a material negative effect on both our financial position and results of operations.

While management has a plan to return the Company's business fundamentals to levels that support the book value per common share, there is no assurance that the plan will be successful, or that the market price of the common stock will increase to such levels in the foreseeable future. There is no assurance that: (1) valuation multiples will not decline, (2) discount rates will not increase or (3) the earnings, book values or projected earnings and cash flows of the Company's individual reporting segments will not decline. Accordingly, an impairment charge to goodwill and other intangible assets may be required in the foreseeable future if the book equity value exceeds the estimated fair value of the enterprise or of an individual segment.

## Warrant Liability

On June 1, 2009, the Company adopted Emerging Issues Task Force consensus 07-05, "*Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity's Own Stock*" ("EITF 07-05"). EITF 07-05 requires a new 2-step test for determination of whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock. Step 1 is to evaluate the instrument's contingent exercise provisions, if any, and step 2 is to evaluate the instrument's settlement provisions. The Company evaluated its existing current instruments previously classified as equity immediately prior to the adoption of EITF 07-05 and determined that the warrants issued in conjunction with its Senior Secured Notes Payable are not indexed to the Company's own stock under the requirements of EITF 07-05 due primarily to the reset provisions of the warrant in the event of lower priced financing transactions. Therefore, they were reclassified out of equity to a liability classification as of June 1, 2009 via a cumulative effect adjustment (as required by EITF 07-05). Subsequent changes to the fair value of the liability after June 1, 2009 will be included in the consolidated statements of operations and comprehensive loss. The table below details the effect of the adoption of EITF 07-05 on the Company's financial statements as of June 1, 2009:

	<u>May 31, 2009</u>	<u>Effect of Adoption of EITF 07-05</u>	<u>June 1, 2009</u>
Common stock warrant liability	-	876,400 <sup>(1)</sup>	876,400
Additional paid-in capital	18,269,589	(338,800) <sup>(2)</sup>	17,930,789
Accumulated deficit	(136,876,313)	(537,500) <sup>(3)</sup>	(137,413,813)

(1) Fair value of warrants on May 31, 2009.

(2) Fair value of warrants upon issuance on August 29, 2008.

(3) Cumulative change in fair value of warrants from August 29, 2008 through May 31, 2009.

The fair value of the warrants were valued using a lattice-based valuation model with the following key inputs:

	<u>August 29, 2008</u>	<u>May 31, 2009</u>	<u>August 31, 2009</u>
Stock Price	\$ 0.20	\$ 0.37	\$ 0.21
Exercise Price	\$ 0.25	\$ 0.25	\$ 0.25
Expected volatility	74%-117%	94%-194%	69%-172%
Expected dividend yield	0%	0%	0%
Expected term (in years)	3.9	3.2	2.9
Risk-free interest rate	1.97%-2.60%	.14%-1.42%	.06%-.95%

## Fair Value of Financial Instruments

In June 2008, the Company adopted Statement of Financial Accounting Standards (“FAS”) No. 157, “Fair Value Measurements,” (“FAS No. 157”) and FASB Staff Position (“FSP”) 157-1, “Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13,” (“FSP FAS 157-1”) to value its financial assets and liabilities. The adoption of FAS No. 157 and FSP FAS 157-1 did not have a significant impact on the Company’s results of operations, financial position or cash flows.

FAS No. 157 defines fair value, establishes a framework for measuring fair value under GAAP and expands disclosures about fair value measurements. FAS No. 157 defines fair value as the exchange price that would be paid by an external party for an asset or liability (exit price) and emphasizes that fair value is a market-based measurement, not an entity-specific measurement. FSP FAS 157-1 amends FAS No. 157 to remove certain leasing transactions from its scope. FAS No. 157 also establishes a fair value hierarchy which requires an entity to classify the inputs used in measuring fair value for assets and liabilities as follows:

- *Level 1* – Inputs are unadjusted quoted market prices in active markets for identical assets or liabilities available at the measurement date;
- *Level 2* – Inputs are unadjusted quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, inputs other than quoted prices that are observable and inputs that are corroborated by observable market data; and
- *Level 3* – Inputs are unobservable inputs that are supported by little or no market activity, therefore requiring an entity to develop its own assumptions about the assumptions that market participants would use in pricing the asset or liability based on the best available information.

Fair value estimates discussed herein are based upon certain market assumptions and pertinent information available to management as of August 31, 2009. The Company uses the market approach to measure fair value for its Level 1 financial assets which includes cash equivalents. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. There were no cash equivalents as of August 31, 2009. The respective carrying value of certain on-balance-sheet financial instruments approximated their fair values due to the short-term nature of these instruments. These instruments include cash, accounts receivable, accounts payable and accrued liabilities.

The Company’s Senior Secured Notes were initially valued using multiple, probability-weighted cash flow outcomes at credit-risk adjusted market rates. The fair value of the Notes is being accreted to the Face Value including accrued interest of \$22,835,685 until August 29, 2010 through interest expense using the effective interest method. The fair value of the Notes on August 31, 2009 was \$20,667,195, including accrued interest thereon.

The embedded put derivative on the Company’s Senior Secured Notes was valued in accordance with FAS No. 157 using multiple, probability-weighted cash flow outcomes (Level 3 inputs) at credit-risk adjusted market rates (Level 2 inputs). The Company’s warrants related to the Notes were valued using a lattice-based valuation model with the inputs detailed above under Warrant Liability.

The following table details the change in the fair value of our financial instruments using significant unobservable inputs (Level 3) during the three months ended August 31, 2009:

	Embedded Put Derivative	Warrant Liability	Total
Fair value as of May 31, 2009	493,693	876,400 <sup>(1)</sup>	1,370,093
Change in fair value of warrants and derivative	27,333	(450,800)	(423,467)
Fair value as of August 31, 2009	521,026	425,600	946,626

(1) Fair value of warrants as of May 31, 2009 recorded as a liability in the Company’s financial statements upon initial adoption of EITF 07-05 on June 1, 2009.

In February 2008, FASB issued FSP FAS 157-2, “Effective Date of FASB Statement No. 157,” which amends FAS No. 157 by delaying its effective date by one year for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. Accordingly, the Company began applying fair value measurements for all non-financial assets and non-financial liabilities on June 1, 2009. This application

did not have a significant impact on the Company's results of operations, financial position or cash flows for the three months ended August 31, 2009.

### **Derivative Financial Instruments**

The Company's Senior Secured Notes contain a contingent put reflected in the contractual rights of default. Under these provisions, the Holder has the right to put the Notes back to the Company for 110% of face value in the event of certain equity-indexed defaults, such as listing failure and non-delivery of common shares issuable upon exercise of certain warrants. Under FAS No. 133, "*Accounting for Derivative Financial Instruments and Hedging Activities*," the risks of equity are inconsistent with the risks of the debt host and, therefore, embedded put derivatives such as these require bifurcation and separate classification at fair value. The embedded put derivative and certain Company issued warrants are recorded at fair value, marked-to-market at each reporting period and classified in the Company's balance sheet as a separate line item.

### **Revenue Recognition**

The Company derives revenue from various sources including the following: subscription and hosting fees; licensing of software and related maintenance fees; professional services related to software implementation, customization and training; sale of products and tickets through the Company's employee rewards software module; career transition services; recruitment research services; and, applicant sourcing.

In general, the Company recognizes revenue when all of the revenue recognition criteria are met, which is typically when:

- evidence of an arrangement exists;
- services have been provided or goods have been delivered;
- the price is fixed or determinable; and
- collection is reasonably assured.

The Company primarily provides various HCM software applications as an on-demand application service and also enters into the sale of license agreements. Revenue is generated through a variety of contractual arrangements.

Subscription and hosting fees and software maintenance fees are billed in advance on a monthly, quarterly or annual basis. Amounts that have been invoiced are recorded in accounts receivable and in deferred revenue or revenue, depending on whether the revenue recognition criteria have been met. Quarterly and annual payments are deferred and recognized monthly over the service period on a straight-line basis. Set up fees are deferred and recognized monthly on a straight-line basis over the contractual lives of the customer.

Subscription revenues and hosting fees consist of fees from customers accessing our on-demand application service. The Company follows the provisions of SEC Staff Accounting Bulletin No. 104, *Revenue Recognition* and Emerging Issues Task Force Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. For revenue arrangements with multiple deliverables, the Company allocates the total customer arrangement to the separate units of accounting based on their relative fair values, as determined by the price of the undelivered items when sold separately. Professional services included in an application services arrangement with multiple deliverables are accounted for separately when these services have value to the customer on a standalone basis, and there is objective and reliable evidence of fair value of each undeliverable item of the arrangement. When accounted for separately, revenues are recognized as the services are rendered.

License revenues consist of fees earned from the granting of both perpetual and term licenses to use the software products. The Company recognizes revenue from the sale of software licenses in accordance with American Institute of Certified Public Accountants ("AICPA") Statement of Position ("SOP") No. 97-2, *Software Revenue Recognition*, and SOP No. 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*, when all of the following conditions are met: a signed contract exists; the software has been shipped or electronically delivered; the license fee is fixed or determinable; and the Company believes that the collection of the fees is reasonably assured. License revenue is recorded upon delivery with an appropriate deferral for maintenance services, if applicable, provided all of the other relevant conditions have been met. The total fee from the arrangement is allocated based on Vendor Specific Objective Evidence ("VSOE") of fair value of each of the undelivered elements. Maintenance agreements are typically priced based on a percentage of the product license fee and are either multi-year or have a one-year term, renewable annually. VSOE of fair value for maintenance is established based on the stated renewal rates. Services provided to customers under maintenance agreements include technical product support and unspecified product upgrades. VSOE of fair value for the

professional service element is based on the standard hourly rates the Company charges for services when such services are sold separately.

Source code revenue is generated by sales in small markets that we do not typically target. The sales are for old versions of specific applications or products that we no longer support or sell. As such, future earnings are not affected by these sales. The Company recognizes revenue when all of the revenue recognition criteria are met, which is typically when the services have been completed.

Professional services revenue is generated from implementation of software applications and from customer training, customization and general consulting. In addition, revenue is generated from technical support not included in the software maintenance. The majority of professional services revenue is billed based on an hourly rate and recognized on a monthly basis as services are provided. For certain contracts which involve significant implementation or other services which are essential to the functionality of the software and which are reasonably estimable, the license and implementation services revenue is recognized using contract accounting, as prescribed by SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. Revenue is recognized over the period of each implementation using the percentage-of-completion method. Labor hours incurred is used as the measure of progress towards completion, and management believes its estimates to completion are reasonably dependable. A provision for estimated losses on engagements is made in the period in which the losses become probable and can be reasonably estimated.

One of the software applications offered by the Company allows customers to offer rewards, employee recognition and benefits in an effort to promote their employee retention. The Company generates subscription revenues from the customer. In addition, the Company generates revenue from the sale of products and tickets to the customers' employees through a website. The Company recognizes revenue when all of the revenue recognition criteria are met, which is typically when the goods are shipped and title has transferred.

For career transition services, the Company bills the client 50% when the assignment starts and the remaining 50% when the assignment is completed or upon a later date as agreed. The Company recognizes revenue when all of the revenue recognition criteria are met, which is typically when services have been completed.

For applicant sourcing services, the Company bills its clients in advance on a monthly, quarterly and annual basis. The Company recognizes revenue when all of the revenue recognition criteria are met, which is typically on a straight-line basis as services have been completed. Unrecognized revenue is included in deferred revenue.

As described above, the Company defers certain revenues received and recognizes them ratably over the applicable term of service. If the revenue is expected to be recognized within the next twelve months, it is classified as a current liability on the accompanying consolidated balance sheets. If the revenue is expected to be recognized over a period longer than 12 months, then the portion of revenue expected to be recognized greater than 12 months is classified as a long-term liability.

### **Cost of Goods Sold**

The components of cost of goods sold in the accompanying consolidated statements of operations and comprehensive loss include all direct materials and direct labor associated with the generation of revenue of the Company's software, rewards products and career services.

### **Accounting for Stock-Based Compensation**

On June 1, 2006, the Company adopted the provisions of FAS No. 123R, "Share-Based Payments" ("FAS No. 123R") which requires it to recognize expense related to the fair value of stock-based compensation awards. Stock-based compensation expense for all stock-based compensation awards granted on or subsequent to June 1, 2006 is based on the grant date fair value estimated in accordance with the provisions of FAS No. 123R. Compensation expense for stock option awards is recognized on a straight-line basis over the requisite service period of the award.

We use the Black-Scholes option-pricing model to value our stock option grants under FAS No. 123R. FAS No. 123R also requires us to estimate forfeitures in calculating the expense related to stock-based compensation, and it requires us to reflect cash flows resulting from excess tax benefits related to those options as a cash inflow from financing activities rather than as a reduction of taxes paid.

The assumptions in the table presented below were used to calculate the fair-value of share-based payment awards using the Black-Scholes option pricing model, which values options based on the stock price at the grant date, the expected life of the option, the estimated volatility of the stock, expected dividend payments, and the risk-free interest rate over the expected life of the option. The dividend yield was calculated by dividing the current annualized dividend by the option exercise price of each grant. The expected volatility was determined considering the Company's historical stock prices for the fiscal year the grant occurred and prior fiscal years for a period equal to the expected life of the option. The risk-free rate represents the US Treasury bond rate with maturity equal to the expected life of the option. The expected life of the option was estimated based on the exercise history of previous grants.

	Three Months Ended	
	August 31, 2009	August 31, 2008
Expected volatility	169%-171%	68%
Expected dividend yield	0%	0%
Expected term (in years)	3.45	3.50
Risk-free interest rate	2.46%-2.71%	3.43%
Forfeiture rate	30%	0%

### **Income Taxes**

The Company follows the provisions of the FASB Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109*," ("FIN 48"). FIN 48 provides guidance on the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company has not recognized a liability as a result of the implementation of FIN 48. A reconciliation of the beginning and ending amount of unrecognized tax benefits has not been provided since there is no unrecognized benefit as of the date of adoption. The Company has not recognized interest expense or penalties as a result of the implementation of FIN 48. If there were an unrecognized tax benefit, the Company would recognize interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. The Company files income tax returns in the U.S. federal jurisdiction and in various states and Canada.

Deferred tax assets and liabilities are determined based on temporary differences between the financial statement and tax basis of assets and liabilities and net operating loss and credit carry-forwards using enacted tax rates in effect for the year in which the differences are expected to reverse in accordance with FAS No. 109, "*Accounting for Income Taxes*." The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Income tax expense is the tax payable or refundable for the period plus or minus the change during the period in deferred tax assets and liabilities. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. In determining the amount of any valuation allowance required to offset deferred tax assets, an assessment is made that includes anticipating future income and determining the likelihood of realizing deferred tax assets. Management has determined that there is sufficient uncertainty regarding the ultimate realization of deferred tax assets relating to the United States operations and therefore, has provided a valuation allowance for the entire balance of the deferred tax assets.

### **Foreign Currency Translation**

These consolidated financial statements are presented in U.S. dollars. The parent company is located in Canada, and the functional currency of the parent company is the Canadian dollar. The Company's subsidiaries use their local currency, which is the U.S. dollar, as their functional currency. Adjustments resulting from translating foreign functional currency financial statements into U.S. dollars are recorded as a separate component of stockholders' deficit. All assets and liabilities denominated in a foreign currency are translated into U.S. dollars at the exchange rate on the balance sheet date. Revenues and expenses are translated at the average exchange rate during the period. Equity transactions are translated using historical exchange rates. Foreign currency transaction gains and losses are included in other income and expenses in the consolidated statements of operations and comprehensive loss and have not been material during the periods presented.

### **Earnings (Loss) per Common Share**

Basic earnings (loss) per common share is computed by dividing net income (loss) by the weighted average shares outstanding. Diluted net earnings (loss) per common share is computed by dividing net income (loss) by the weighted average shares outstanding including potential common shares which would arise from the exercise of restricted stock units, stock options, warrants and escrowed shares using the treasury stock method.

## **Segments**

The Company's chief operating decision maker is its Chief Executive Officer, who reviews financial information primarily based on two reportable segments. Accordingly, in accordance with FAS No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FAS No. 131), the Company has determined that it has two reporting segments: Enterprise Workforce Services and Career Networks (see Note 7).

## **Subsequent Events**

The Company has evaluated, accounted for and disclosed, as necessary, all subsequent events from the balance sheet date through October 15, 2009 at the time of issuance of the financial statements.

## **Recent Accounting Pronouncements**

In November 2008, the FASB issued FAS No. 168, "*The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles (as amended)*" ("FAS No. 168"). FAS No. 168 states that the FASB Accounting Standards Codification will become the source of authoritative U.S. generally accepted accounting principles (GAAP) and it will also include all rules and interpretive releases of the Securities and Exchange Commission. On September 15, 2009 the Codification superseded all then-existing non-SEC accounting and reporting standards. FAS No. 168 is effective for interim and annual periods ending after September 15, 2009. There will be no impact on the Company's results of operations and financial position upon adoption of FAS No. 168 in the second quarter of fiscal 2010.

In June 2009, the FASB issued FAS No. 166, "*Accounting for Transfers of Financial Assets, an amendment to FAS No. 140.*" The new standard eliminates the concept of a "qualifying special-purpose entity," changes the requirements for derecognizing financial assets, and requires additional disclosures in order to enhance information reported to users of financial statements by providing greater transparency about transfers of financial assets, including securitization transactions, and an entity's continuing involvement in and exposure to the risks related to transferred financial assets. FAS No. 166 is effective for fiscal years beginning after November 15, 2009. The Company is currently evaluating the impact of adopting FAS No. 166 on its results of operations and financial position.

## **NOTE 2. RECLASSIFICATIONS**

Certain reclassifications have been made in the accompanying fiscal 2009 financial statements to conform to the current year presentation.

In February 2008, Workstream engaged an investment bank to advise and consider divesting its 6Figurejobs.com (6FJ) division and in August 2008, the Board agreed to actively move forward with the plan. The move was designed to infuse the Company with cash, as well as to reduce its debt burden. As a result, the Company presented the carrying value of the 6FJ assets and liabilities as Assets Held for Sale in the Balance Sheet as of August 31, 2008. Additionally, 6FJ's results of operations for the three months ended August 31, 2008 were presented as Income from Discontinued Operations Net of Taxes in the Company's Unaudited Consolidated Statements of Operations. However, due to the economic conditions, Workstream discontinued any active marketing to sell this division in the third quarter of fiscal 2009. The 6FJ results for the three months ended August 31, 2008 as presented herein are now reclassified to appear in their respective line items within the Company's Unaudited Consolidated Statements of Operations and Comprehensive Loss.

The following table provides a reconciliation of the Company's Unaudited Consolidated Statements of Operations as reported in the 10-Q for the period ended August 31, 2008 to the amounts reported herein:

	<b>Three Months Ended</b>		
	<b>August 31, 2008</b>	<b>August 31, 2008</b>	
	<b>(as reported)</b>	<b>Reclass</b>	<b>(as reclassified)</b>
Revenues	\$ 4,935,434	\$ 617,453	\$ 5,552,887
Cost of revenues	1,601,214	1,256	1,602,470
Gross profit	3,334,220	616,197	3,950,417
Operating expenses:			
Selling and marketing	993,779	308,828	1,302,607
General and administrative	2,667,492	257,994	2,925,486
Research and development	1,302,102	-	1,302,102
Amortization and depreciation	480,008	766	480,774
Total operating expenses	5,443,381	567,588	6,010,969
Operating loss	(2,109,161)	48,609	(2,060,552)
Other income (expense):			
Interest income and expense, net	140,256	(136,666)	3,590
Other income and expense, net	(73,832)	112,691	38,859
Other expense	66,424	(23,975)	42,449
Loss before income tax expense	(2,042,737)	24,634	(2,018,103)
Income tax expense	(10,679)	(22,800)	(33,479)
Loss from continuing operations	(2,053,416)	1,834	(2,051,582)
Income from discontinued operations net of taxes	1,834	(1,834)	-
<b>NET LOSS</b>	<b>\$ (2,051,582)</b>	<b>\$ -</b>	<b>\$ (2,051,582)</b>

**NOTE 3. ALLOWANCE FOR DOUBTFUL ACCOUNTS**

The following table presents the detail of the changes in the allowance for doubtful accounts:

	Three Months Ended August 31, 2009	Year Ended May 31, 2009
Balance at beginning of the period	\$ 928,430	\$ 509,802
Charged to bad debt expense	152,034	653,826
Write-offs and effect of exchange rate changes	(8,006)	(235,198)
Balance at end of the period	<u>\$ 1,072,458</u>	<u>\$ 928,430</u>

The Company uses historical experience and knowledge of and experience with specific customers in order to assess the adequacy of the allowance for doubtful accounts. Any adjustments to this account are reflected in the accompanying consolidated statements of operations and comprehensive loss as a general and administrative expense.

**NOTE 4. INVESTOR WARRANTS AND SENIOR SECURED NOTES PAYABLE**

On August 29, 2008, we entered into an exchange agreement that provided for the exchange of the \$19,000,000 Special Warrants and Additional Warrants indexed to 3,800,000 shares of common stock, issued August 3, 2007 (“Old Warrants”), for \$19,147,191 in Face Value of Senior Secured Notes (collectively, the “Notes”) and newly issued warrants indexed to 3,800,000 shares of common stock (“New Warrants”) (the “Exchange Transaction”). Financing costs of \$147,191 incurred by the holders of the Notes (“Holders”) are included in the face value of the Notes.

The Notes are secured by a lien on all of our and our subsidiaries' assets pursuant to the terms of a Security Agreement with each Note Holder. Interest on the Notes accrues at an annual rate of 7% until August 29, 2009 and then 12% per year thereafter. The Notes mature on August 29, 2010 and all unpaid principal and accrued interest is due upon maturity.

The New Warrants are convertible into 3,800,000 shares of common stock at an exercise price of \$0.25. All other material terms of the New Warrants are substantially the same as those contained in the old warrants that were exchanged, including the existence of anti-dilution provisions that provide for a full adjustment of the exercise price and the number of common shares to be issued in the event we, in certain circumstances, issue securities at a price below the exercise price of the New Warrants. Each New Warrant must be exercised on or prior to August 3, 2012 or it will expire by its terms.

The Notes also contain a contingent put reflected in the contractual rights of default. Upon the occurrence of an event of default, as defined in the Notes, a Holder may require us to redeem all or a portion of such Holder's Note at a price equal to 110% of the sum of the principal amount of the Note, accrued and unpaid interest and late fees, if any, to be redeemed. Under FAS No. 133, "*Accounting for Derivative Financial Instruments and Hedging Activities*," the risks of equity are inconsistent with the risks of the debt host and, therefore, embedded put derivatives such as these require bifurcation and separate classification at fair value.

Upon a Disposition (as defined in the Notes) of assets, we agreed to use 75% of the gross proceeds net of taxes to redeem the Notes (on a pro rata basis among the Holders). The remaining 25% of the gross proceeds net of taxes (such amount not to exceed \$2,500,000) may be retained by us. In addition, in the event that we receive cash, cash equivalents or publicly-traded securities in an amount exceeding \$2,000,000 in connection with the settlement of certain litigation involving us, we agreed to use 75% of the amount received in excess of \$2,000,000 to redeem the Notes (on a pro rata basis among the Holders). Each Note contains customary covenants with which we must comply. Each of our subsidiaries delivered a Guaranty pursuant to which it agreed to guarantee our obligations under each Note.

The note payable contains covenants that, among other things, limit our ability and the ability of our subsidiaries to:

- Incur additional indebtedness;
- create liens;
- pay dividends or repurchase capital stock;
- make certain other payments; and
- sell or transfer assets.

On May 22, 2009, the Company's stock was suspended from trading on the NASDAQ Stock Market due to its inability to maintain a minimum of \$2.5 million in stockholders' equity or \$500,000 of net income from continuing operations for the most recently completed fiscal year or two of the three most recently completed fiscal years. The suspension constituted an event of default under the Notes and thereby entitled each Holder of the Notes to require the Company to redeem all or a portion of the Holder's Note at a price equal to 110% of the sum of the principal amount of the Note, accrued and unpaid interest and late fees, if any. Additionally, as a result of the event of default, the interest rate under each Note was increased by 5% in addition to the contractual rate of interest due.

In August 2009, the Company signed a term sheet with the Holders, whereby the Holders agreed to restructure the Notes. The term sheet provides that the Holders would exchange the Notes and the accrued interest thereon (approximately \$20.7 million as of August 31, 2009) into \$9.5 million of new senior secured notes with the balance as convertible notes. The proposed new notes would accrue interest at a rate of 9.5% per annum and have a maturity date of July 31, 2012. The Company and the Holders are negotiating the final terms of the refinancing documents and expect to close the transaction during the Company's second fiscal quarter ending November 30, 2009. However, there can be no assurance that the Company will be successful in its negotiations with the existing Holders and other parties or that the terms of any such refinancing or conversions will not result in the issuance, or potential issuance, of a significant amount of equity securities that will cause substantial dilution to the Company's stockholders.

The Notes and the embedded put derivative were valued in accordance with FAS No. 157 using multiple, probability-weighted cash flow outcomes at credit-risk adjusted market rates. The fair value of the Notes is being accreted to the Face Value including accrued interest of \$22,835,685 until August 29, 2010 through interest expense using the effective interest method. Interest expense on the Notes was \$509,151 during the three months ended August 31, 2009. The (\$27,333) change in the fair value of the embedded put derivative from \$493,693 on May 31, 2009 to \$521,026 on August 31, 2009 is recorded as an expense in the Statements of Operations and Comprehensive Loss during the three months ended August 31, 2009.

On June 1, 2009, the Company adopted EITF 07-05 which required it to begin accounting for the New Warrants as a liability due primarily to the reset provisions of the warrant in the event of lower priced financing transactions. Therefore, they were reclassified out of equity to a liability classification as of June 1, 2009 via a cumulative effect adjustment (see Warrant Liability under Note 1). The \$450,800 change in the fair value of the New Warrants from \$876,400 on June 1, 2009 to \$425,600 on August 31, 2009 is recorded as income in the Statements of Operations and Comprehensive Loss during the three months ended August 31, 2009.

## **NOTE 5. COMMITMENTS AND CONTINGENCIES**

### **Litigation**

On or about August 10, 2005, a class action lawsuit was filed against the Company, its former Chief Executive Officer and its former Chief Financial Officer in the United States District Court for the Southern District of New York. The action, instituted on behalf of a purported class of purchasers of the Company's common shares during the period from January 14, 2005 to and including April 14, 2005 (the class period), alleged, among other things, that management provided the market misleading guidance as to anticipated revenues for the quarter ended February 28, 2005, and failed to correct this guidance on a timely basis. The action claimed violations of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 promulgated thereunder, as well as Section 20(a) of the Exchange Act, and sought compensatory damages in an unspecified amount as well as the award of reasonable costs and expenses, including counsel and expert fees and costs. The Court certified the case as a class action.

The parties agreed to settle the claims in consideration of the payment of \$3 million in cash and \$600,000 in the Company's common shares. The \$3 million was paid for by the Company's insurance carrier pursuant to the Company's insurance policies. The Court held a hearing on June 24, 2008 to consider the fairness of the settlement after notice of the settlement and the hearing had been given to the class. No opposition to approval of the settlement was presented at the hearing. On August 13, 2008, the court entered a final judgment in the case, which became final on September 12, 2008. The \$600,000 was accrued for in fiscal 2007 and 3,636,363 shares were issued in fiscal 2009 on September 24, 2008 after the issuance of the final judgment.

\* \* \*

On February 12, 2008, Workstream, Workstream Merger Sub Inc., Empagio Acquisition LLC ("Empagio") and SMB Capital Corporation entered into an Agreement and Plan of Merger pursuant to which Empagio would merge with and into Workstream, subject to the terms and conditions of the Merger Agreement, which was approved by the Boards of Directors of both the companies. Upon the completion of the Merger, the equity interests in Empagio would be converted into up to 177,397,332 shares of Workstream Inc. common stock, representing approximately 75% of the Company's outstanding common stock on a diluted basis following the Merger.

On June 24, 2008, the Company filed a lawsuit in the Superior Court of the State of Delaware in and for New Castle County (the "State Court Lawsuit") against Empagio Acquisition, LLC ("Empagio") and SMB Capital Corporation ("SMB") to obtain the \$5 million termination fee required to be paid by Empagio and SMB pursuant to Section 7.02 of the Agreement and Plan of Merger dated as of February 12, 2008 among the Company, Workstream Merger Sub Inc., Empagio and SMB, which agreement was terminated by the Company on June 13, 2008. On June 25, 2008, Empagio and SMB filed a lawsuit against the Company in the United States District Court for the District of Delaware (the "Federal Lawsuit") alleging entitlement to a \$3 million termination fee pursuant to the Agreement and Plan of Merger. On July 29, 2008, Empagio and SMB filed a notice of voluntary dismissal of their Federal Lawsuit based on an understanding that Empagio and SMB would make their claim as part of the Company's State Court Lawsuit. In accordance with the voluntary notice of dismissal of the Federal Lawsuit, Empagio and SMB have now asserted their claims in the State Court Lawsuit. The Company has denied these allegations. The parties are proceeding with discovery in this case. Trial is scheduled for July 5, 2010, with mandatory alternative dispute resolution to be completed by January 29, 2010.

\* \* \*

On June 10, 2009, Franklin Drive, LLC filed a lawsuit in the Superior Court of the State of California against the Company, its former Chief Executive Officer and its former Chief Financial Officer for a dispute regarding the Company's lease of commercial property located at 5000 Franklin Drive, Pleasanton, California which was for a term commencing on January 1, 2008 and expiring on January 31, 2013. On or about October 2008, we abandoned the property and ceased making rental

payments pursuant to the lease. Franklin Drive, LLC is claiming termination damages of \$1.5 million, but seeking actual settlement at terms considerably less than this amount. The parties are engaged in out-of-court, settlement negotiations and we expect to continue settlement negotiations until an agreeable settlement amount is reached.

\* \* \*

The Company is subject to other legal proceedings and claims which arise in the ordinary course of business. The Company does not believe that the resolution of such actions will materially affect the Company's business, results of operations, financial condition or cash flows.

## **NOTE 6. CAPITAL STOCK**

### **Classes of Stock**

The authorized share capital consists of an unlimited number of no par value common shares, an unlimited number of no par value Class A Preferred Shares (the "Class A Preferred Shares"), and an unlimited number of no par value Series A Convertible Preferred Shares (the "Series A Shares"). There were 56,993,312 common shares issued and outstanding as of August 31, 2009. There were no Class A Preferred Shares or Series A Shares outstanding as of August 31, 2009.

### **Stock Plans and Stock-Based Compensation**

The Company grants stock options to employees, directors and consultants under the 2002 Amended and Restated Stock Option Plan (the "Plan"), which was most recently amended in November 2007 at the annual shareholders' meeting. Under the Plan, as amended, the Company is authorized to issue up to 11,000,000 shares of common stock upon the exercise of stock options or restricted stock unit grants. The Audit Committee of the Board of Directors administers the Plan. Under the terms of the Plan, the exercise price of any stock options granted shall not be lower than the market price of the common stock on the date of the grant. Options to purchase shares of common stock generally vest ratably over a period of three years and expire five years from the date of grant.

On June 1, 2006, the Company adopted the provisions of FAS No. 123R, which requires it to recognize expense related to the fair value of stock-based compensation awards. Stock-based compensation expense for all stock-based compensation awards granted on or subsequent to June 1, 2006 is based on the grant date fair value estimated in accordance with the provisions of FAS No. 123R. Compensation expense for stock option awards is recognized on a straight-line basis over the requisite service period of the award. The assumptions used to calculate the fair-value of share-based payment awards during the three months ended August 31, 2009 and 2008 are found in Note 1 under Accounting for Stock-Based Compensation.

The Company recognized \$20,217 and \$66,254 of stock-based compensation expense resulting from stock options in the consolidated statements of operations and comprehensive loss under general and administrative expenses for the three months ended August 31, 2009 and 2008, respectively.

Stock option activity and related information is summarized as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Fair Value	Weighted Average Remaining Contractual Term in Years	Aggregate Intrinsic Value
Balance outstanding - May 31, 2008	2,356,548	\$ 1.23			
Granted	27,600	\$ 0.17	\$ 0.09		
Exercised	-	\$ -			
Forfeited or expired	(957,116)	\$ 1.37			
Balance outstanding - May 31, 2009	1,427,032	\$ 1.12			
Granted	849,500	\$ 0.31	\$ 0.27		
Exercised	-	-			
Forfeited or expired	(109,367)	\$ 1.49			
Balance outstanding - August 31, 2009	<u>2,167,165</u>	<u>\$ 0.78</u>		<u>3.4</u>	<u>\$ 192</u>
Exercisable - August 31, 2009	<u>1,135,516</u>	<u>\$ 1.13</u>		<u>2.5</u>	<u>\$ 64</u>

The aggregate intrinsic value in the table above represents total intrinsic value (of options in the money), which is the difference between the Company's closing stock price of \$0.21 on August 31, 2009, the last trading day of the reporting period and the exercise price times the number of shares, that would have been received by the option holders had the option holders exercised their options on August 31, 2009.

There were no options exercised during the three months ended August 31, 2009 and 2008; and therefore, no intrinsic value or cash received from option exercises during the period.

The following table summarizes information about options outstanding at August 31, 2009:

Range of Exercise Prices	Options Outstanding (#)	Weighted- Average Remaining Contractual Life	Weighted- Average Exercise Price	Options Exercisable (#)	Weighted- Average Remaining Contractual Life	Weighted- Average Exercise Price
\$0.18 - \$0.99	1,624,300	4.0 years	\$ 0.52	617,929	3.2 years	\$ 0.76
\$1.00 - \$1.99	470,134	1.8 years	\$ 1.34	444,856	1.7 years	\$ 1.34
\$2.00 - \$2.99	37,200	0.4 years	\$ 2.73	37,200	0.4 years	\$ 2.73
\$3.00 - \$3.25	35,531	0.4 years	\$ 3.25	35,531	0.4 years	\$ 3.25
Total	<u>2,167,165</u>	<u>3.4</u> years	<u>\$ 0.78</u>	<u>1,135,516</u>	<u>2.5</u> years	<u>\$ 1.13</u>

As of August 31, 2009, \$189,934 of total unrecognized compensation costs related to non-vested stock options is expected to be recognized ratably over the remaining individual vesting periods up to three years. The realized tax benefit from stock options and other share based payments was \$0 for the three months ended August 31, 2009 and 2008 due to the uncertainty of realizability.

The Company grants restricted stock units to certain management and members of the Board of Directors. Each restricted stock unit represents one share of common stock and vests ratably over three years. The Company will then issue common stock for the vested restricted stock units upon exercise by the grantee. During the vesting period, the restricted stock units cannot be transferred, and the grantee has no voting rights. The cost of the awards, determined as the fair value of the shares on the grant date, is expensed ratably over the vesting period. The stock-based compensation expense associated with the restricted stock units totaling \$14,938 and \$27,433 for the three months ended August 31, 2009 and 2008, respectively, is included in general and administrative expenses on the consolidated statements of operations and comprehensive loss and in additional paid-in capital on the consolidated balance sheets. As of August 31, 2009, \$80,128 of

total unrecognized compensation costs related to non-vested restricted stock unit grants is expected to be recognized ratably over the remaining individual vesting periods up to three years.

	Number of Options	Weighted Average Fair Value
Outstanding - May 31, 2008 **	486,670	
Granted	200,926	\$ 0.27
Vested	(549,822)	
Forfeited or expired	(60,000)	
Non-vested - May 31, 2009	<u>77,774</u>	
Granted	160,000	\$ 0.34
Vested	-	
Forfeited or expired	-	
Non-vested - August 31, 2009	<u><u>237,774</u></u>	

\*\* At May 31, 2008, 486,670 restricted stock units were outstanding including 264,444 that were fully vested but not issued.

As of August 31, 2009, the Company had outstanding warrants to purchase shares of common stock which were issued in connection with past financing arrangements. Information related to these warrants is summarized as follows:

Exercise Price	Expiration Date	Shares
\$ 0.01	October 2011	2,350,000
\$ 0.25	August 2012	2,800,000
		<u><u>5,150,000</u></u>

#### **NOTE 7. SEGMENT AND GEOGRAPHIC INFORMATION**

The Company has two reportable segments: Enterprise Workforce Services and Career Networks. Enterprise Workforce Services consists of revenue generated from HCM software and related professional services. In addition, Enterprise Workforce Services generates revenue from the sale of various products through the rewards modules of the HCM software. Career Networks primarily consists of revenue from career transition, applicant sourcing and recruitment research services.

The Company evaluates the performance in each segment based on profit or loss from operations. There are no inter-segment sales. Corporate operating expenses are allocated to the segments primarily based on revenue.

The Company's segments are distinct business units that offer different products and services. Each is managed separately and each has a different client base that requires a different approach to the sales and marketing process.

The Company does not allocate other income and expense items such as interest income and expense, change in fair value of warrants and derivative, loss on extinguishment of debt and other income and expense, as well as income tax expense in the profit and loss presentation for its segments. The Company also does not allocate certain assets such as cash and cash equivalents to the segments for asset presentation. The Company deems these costs to be corporate costs that would not necessarily be a part of the individual segments ordinary course of business or does not record these assets by segment.

The following tables summarize the Company's operations by business segment and by geographic region for the three months ended August 31, 2009 and 2008:

**Business Segment Information**

	Three Months Ended August 31, 2009		
	Enterprise Workforce Services	Career Networks	Total
Software	\$ 1,502,211	\$ -	\$ 1,502,211
Professional services	234,338	-	234,338
Rewards	1,527,930	-	1,527,930
Career services	-	947,266	947,266
Revenue, net	<u>3,264,479</u>	<u>947,266</u>	<u>4,211,745</u>
Cost of revenues	<u>1,230,713</u>	<u>58,975</u>	<u>1,289,688</u>
Gross profit	2,033,766	888,291	2,922,057
Expenses	1,960,398	947,265	2,907,663
Amortization and depreciation	275,190	6,587	281,777
Business segment loss	<u>\$ (201,822)</u>	<u>\$ (65,561)</u>	<u>(267,383)</u>
Other income and expense and income tax			<u>(92,499)</u>
Net loss			<u>\$ (359,882)</u>

	As of August 31, 2009		
	Enterprise Workforce Services	Career Networks	Total
Business segment assets	\$ 2,742,893	\$ 611,696	\$ 3,354,589
Intangible assets	-	-	-
Goodwill	<u>11,381,660</u>	<u>6,347,788</u>	<u>17,729,448</u>
	<u>\$ 14,124,553</u>	<u>\$ 6,959,484</u>	<u>21,084,037</u>
Assets not allocated to business segments			<u>1,068,224</u>
Total assets			<u>\$ 22,152,261</u>

**Business Segment Information (continued)**

	Three Months Ended August 31, 2008		
	Enterprise Workforce Services	Career Networks	Total
Software	\$ 1,791,457	\$ -	\$ 1,791,457
Professional services	721,971	-	721,971
Rewards	1,518,915	-	1,518,915
Career services	-	1,520,544	1,520,544
Revenue, net	<u>4,032,343</u>	<u>1,520,544</u>	<u>5,552,887</u>
Cost of revenues	<u>1,495,088</u>	<u>107,382</u>	<u>1,602,470</u>
Gross profit	<u>2,537,255</u>	<u>1,413,162</u>	<u>3,950,417</u>
Expenses	3,722,097	1,808,098	5,530,195
Amortization and depreciation	462,736	18,038	480,774
Business segment loss	<u>\$ (1,647,578)</u>	<u>\$ (412,974)</u>	<u>(2,060,552)</u>
Other income and expense and income tax			<u>8,970</u>
Net loss			<u>\$ (2,051,582)</u>

**Geographic Information**Three Months Ended  
August 31, 2009

	Canada	United States	Total
Net Revenue	\$ 297,478	\$ 3,914,267	\$ 4,211,745
Expenses	672,440	3,806,688	4,479,128
Geographical loss	<u>\$ (374,962)</u>	<u>\$ 107,579</u>	<u>(267,383)</u>
Other income and expense and income tax			(92,499)
Net loss			<u>\$ (359,882)</u>

As of  
August 31, 2009

	Canada	United States	Total
Long-lived assets	\$ 489,053	\$ 18,024,390	\$ 18,513,443
Current assets			3,638,818
Total assets			<u>\$ 22,152,261</u>

Three Months Ended  
August 31, 2008

	Canada	United States	Total
Net Revenue	\$ 306,646	\$ 5,246,241	\$ 5,552,887
Expenses	1,243,815	6,369,624	7,613,439
Geographical loss	<u>\$ (937,169)</u>	<u>\$ (1,123,383)</u>	<u>(2,060,552)</u>
Other income and expense and income tax			8,970
Net loss			<u>\$ (2,051,582)</u>

**NOTE 8. EARNINGS (LOSS) PER SHARE**

The following is a reconciliation of basic net income per share to diluted net income per share:

	Three Months Ended	
	August 31, 2009	August 31, 2008
Net loss	\$ <u>(359,882)</u>	\$ <u>(2,051,582)</u>
Weighted average shares outstanding – basic	56,993,312	52,442,818
Potential shares “in-the-money” under stock option and warrant agreements	-	-
Less: Shares assumed repurchased under the treasury stock method	-	-
Weighted average shares outstanding –diluted	<u>56,993,312</u>	<u>52,442,818</u>
Basic net loss per common share	\$ <u>(0.01)</u>	\$ <u>(0.04)</u>
Diluted net loss per common share	\$ <u>(0.01)</u>	\$ <u>(0.04)</u>

Because the Company reported a net loss during the three months ended August 31, 2009 and 2008, the Company excluded the impact of its common stock equivalents in the computation of dilutive earnings per share for these periods, as their effect would be anti-dilutive. The following outstanding instruments could potentially dilute earnings per share in the future:

Total dilutive instruments:	
Stock options	2,167,165
Restricted stock units	237,774
Escrowed shares	108,304
Warrants	5,150,000
Total potential dilutive instruments	<u>7,663,243</u>

**NOTE 9. ECONOMIC DEPENDENCE**

The Company had one customer which represented approximately 20% and 18% of net revenue for the three months ended August 31, 2009 and 2008, respectively, and one customer which represented approximately 14% of accounts receivable at August 31, 2009.

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

### **FORWARD LOOKING STATEMENTS**

Certain statements discussed in Item 2 (Management's Discussion and Analysis of Financial Condition and Results of Operations) and elsewhere in this Form 10-Q constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements concerning management's expectations, strategic objectives, business prospects, anticipated economic performance and financial condition and other similar matters involve known and unknown risks, uncertainties and other important factors that could cause the actual results, performance or achievements of results to differ materially from any future results, performance or achievements discussed or implied by such forward-looking statements. Such risks, uncertainties and other important factors are described in Items 1A (Risk Factors) and 7 (Management's Discussion and Analysis of Financial Condition and Results of Operations) of the Company's Form 10-K for the fiscal year ended May 31, 2009 and in Item 1A of Part II hereunder. The words "estimate," "project," "intend," "believe," "plan" and similar expressions are intended to identify forward-looking statements. Forward-looking statements speak only as of the date of the document in which they are made. The Company disclaims any obligation or undertaking to provide any updates or revisions to any forward-looking statement to reflect any change in the Company's expectations or any change in events, conditions or circumstances on which the forward-looking statement is based.

The following discussion and analysis should be read in conjunction with our audited consolidated financial statements and related notes included in our Annual Report on Form 10-K as filed on September 14, 2009 and in conjunction with our unaudited consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q. All figures are in United States dollars, except as otherwise noted.

### **OVERVIEW**

We are a provider of services and web-based software applications for Human Capital Management ("HCM"). HCM is the process by which companies recruit, train, compensate, evaluate performance, motivate, develop and retain their employees. We offer software and services that address the needs of companies to more effectively manage their HCM functions. We believe that our broad array of HCM solutions provide a "one-stop-shopping" approach for our clients' human resource needs and is more efficient and effective than traditional methods of human resource management.

Our business changed beginning in fiscal 2002. During fiscal 2002, we completed the acquisitions of Paula Allen Holdings, OMNIpartners, 6FigureJobs.com, RezLogic, ResumeXpress and Tech Engine. During fiscal 2003, we completed the acquisitions of Icarian, PureCarbon and Xylo. During fiscal 2004, we completed the acquisitions of Perform, Peopleview and Kadiri. During fiscal 2005, we completed the acquisitions of Peoplebonus, Bravanta, HRSoft and ProAct. During fiscal 2006, we acquired Exxceed, Inc. These acquisitions have enabled us to expand and enhance our HCM software, increase our service offerings and increase our revenue streams. Subsequent to the acquisitions, we have concentrated on integrating the acquired entities and technologies, expanding the reach of the existing business and identifying other potential acquisition targets. When we complete an acquisition, we combine the business of the acquired entity into the Company's existing operations and expect that this will significantly reduce the administrative expenses associated with the business prior to the acquisition. The acquired business is not maintained as a standalone business operation. Therefore, we do not separately account for the acquired business, including its profitability. Rather, it is included in one of our two distinct business segments and is evaluated as part of the entire segment.

Over the past three years, we have expended significant resources on further integration of the acquired software applications. We have enhanced product functionality, user interface and reporting capabilities. We have further integrated many of the talent management solutions and provide a portal based platform for our customers who may elect to contract for a single solution or multiple applications.

In the last half of fiscal 2008, we initiated objectives that were a part of a strategy to align expenses with revenues of the business. Our overall strategic objective is still to be the premier provider of talent management solutions in the HCM

space. We completed our development of our seamless integration between our core applications of Compensation, Performance, and Development. We are capitalizing on the sales and marketing expenditures and continue to maintain momentum of selling to new customers and retaining existing customers. We believe that sound execution of these initiatives will result in revenue growth and the ability to take advantage of the scalable nature of our business model.

We have two distinct operating segments, which are the Enterprise Workforce Services and Career Networks segments.

### **Enterprise Workforce Services**

The Enterprise Workforce Services segment primarily consists of HCM software, professional services and additional products sold as part of rewards programs. Specifically, our Enterprise Workforce segment offers a complete suite of on-demand HCM software solutions, which address performance, compensation, development, recruitment, benefits and rewards. Workstream provides on-demand compensation, performance and talent management solutions and services that help companies manage the entire employee lifecycle - from recruitment to retirement. We offer software and services that focus on talent management and address the needs of companies to more effectively manage their Human Capital Management (HCM) functions. Talent Management is the process by which companies recruit, train, evaluate, motivate, develop and retain their employees. We believe that our integrated TalentCenter Solution Suite, which brings together our entire modular stand-alone applications on a common platform, is more efficient and effective than traditional methods of human resource management. Access to our TalentCenter Solution Suite is offered on a monthly subscription basis under our web-based Software-as-a-Service (SaaS) delivery model designed to help companies build high performing workforces, while controlling costs.

### **Career Networks**

The Career Networks segment consists of career transition and applicant sourcing services.

#### ***Career Transition Services***

Our career transition services provide job search services for displaced employees. We focus on creating professional career marketing materials that displaced employees need in order to immediately begin their new job campaign. This package includes a professionally written résumé, broadcast letter, custom cover letter and references. This assistance is provided to thousands of job seekers each year in the areas of information technology, engineering, finance and marketing.

#### ***Applicant Sourcing***

6FigureJobs.com, Inc., is an online applicant-sourcing portal where job seeking candidates and companies that are actively hiring and filling positions can interact. The site provides content appropriate for senior executives, directors and other managers, as well as containing job postings that meet their qualifications. We employ screening to create this exclusive community of job seekers. On the candidate side, each job seeker is hand reviewed, to ensure they have recent total compensation of \$100,000 per annum, before his or her resume is allowed to reside in the site's candidate database. On the recruiting side, all job openings must have a minimum aggregate compensation of \$100,000. We generate revenue through 6FigureJobs on a subscription basis from employers and recruiters that access our database of job seekers and use our tools to post, track and manage job openings. We also generate revenue by charging companies that advertise on our 6FigureJobs website, which includes charging certain advertisers a fee based on the number of leads delivered or on a cost per lead basis. Launched in early calendar 2009, executives who wish to access additional jobs, or give their resume and profile more exposure than free membership, may subscribe to a premium service for a small monthly fee.

## **KEY PERFORMANCE INDICATORS**

To monitor our results of operations and financial condition, we review key financial information including net revenues, gross profit, operating income and cash flow from operations. We have deployed numerous analytical dashboards across our business to assist in evaluating current performance against established metrics, budgets and business objectives on an ongoing basis. We continue to seek methods to more efficiently monitor and manage our business performance.

The following table summarizes the key performance indicators that we consider to be material in managing our business, in thousands (except percentages):

	Three Months Ended August 31, 2009				Three Months Ended August 31, 2008			
	Enterprise		Total	% of Revenue	Enterprise		Total	% of Revenue
	Workforce Services	Career Networks			Workforce Services	Career Networks		
Software	\$ 1,502,211	\$ -	\$ 1,502,211	36%	\$ 1,791,457	\$ -	\$ 1,791,457	32%
Professional services	234,338	-	234,338	6%	721,971	-	721,971	13%
Rewards	1,527,930	-	1,527,930	36%	1,518,915	-	1,518,915	27%
Career services	-	947,266	947,266	22%	-	1,520,544	1,520,544	28%
Revenue, net	3,264,479	947,266	4,211,745	100%	4,032,343	1,520,544	5,552,887	100%
Cost of revenues	1,230,713	58,975	1,289,688	31%	1,495,088	107,382	1,602,470	29%
Gross profit	2,033,766	888,291	2,922,057		2,537,255	1,413,162	3,950,417	
	62%	94%	69%		63%	93%	71%	

	Three Months Ended	
	August 31, 2009	August 31, 2008
Net loss, per GAAP	\$ (359,882)	\$ (2,051,582)
Interest income and expense, net	514,075	(3,590)
Income tax expense	289	33,479
Amortization and depreciation	281,777	480,774
Stock related compensation	35,155	93,687
Change in fair value of warrants and derivative	(423,467)	-
Other income and expense, net	1,602	(38,859)
Merger and acquisition costs	-	16,017
Adjusted EBITDA income (loss)	\$ 49,549	\$ (1,470,074)
Weighted average number of common shares outstanding-basic	56,993,312	52,442,818
Weighted average number of common shares outstanding-diluted	56,993,312	52,442,818
Basic & diluted earnings (loss) per share, per GAAP	(\$0.01)	(\$0.04)
Basic & diluted EBITDA earnings (loss) per share	\$0.00	(\$0.03)

EBITDA and EBITDA per share are non-GAAP financial measures within the meaning of Regulation G promulgated by the Securities and Exchange Commission. EBITDA is commonly defined as earnings before interest, taxes, depreciation and amortization. We believe that EBITDA provides useful information to investors as it excludes transactions not related to the core cash operating business activities including non-cash transactions. We believe that excluding these transactions allows investors to meaningfully trend and analyze the performance of our core cash operations. All companies do not calculate EBITDA in the same manner, and EBITDA as presented by Workstream may not be comparable to EBITDA presented by other companies. Workstream defines EBITDA as earnings or loss from continuing operations before interest, taxes, depreciation and amortization, other income and expense, including effects of foreign currency gains or losses, non-cash stock related compensation, gain or loss on asset disposals or impairment, merger and acquisition costs, and non-recurring goodwill impairment, if applicable.

## RESULTS OF OPERATIONS

The following table sets forth the unaudited consolidated statements of operations data for the periods indicated. Period-to-period comparisons of our financial results may not necessarily be an indication of future performance.

	<b>Three Months Ended</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>August 31, 2009</b>	<b>August 31, 2008</b>		
Revenues:				
Software	\$ 1,502,211	\$ 1,791,457	\$ (289,246)	-16%
Professional services	234,338	721,971	(487,633)	-68%
Rewards	1,527,930	1,518,915	9,015	1%
Career networks	947,266	1,520,544	(573,278)	-38%
Revenues, net	4,211,745	5,552,887	(1,341,142)	-24%
Cost of revenues	1,289,688	1,602,470	(312,782)	-20%
Gross profit	2,922,057	3,950,417	(1,028,360)	-26%
	69%	71%		
Operating expenses:				
Selling and marketing	456,668	1,302,607	(845,939)	-65%
General and administrative	2,021,856	2,925,486	(903,630)	-31%
Research and development	429,139	1,302,102	(872,963)	-67%
Amortization and depreciation	281,777	480,774	(198,997)	-41%
Total operating expenses	3,189,440	6,010,969	(2,821,529)	-47%
Operating loss	(267,383)	(2,060,552)	1,793,169	-87%
Other income (expense):				
Interest income and expense, net	(514,075)	3,590	(517,665)	-14420%
Change in fair value of warrants and derivative	423,467	-	423,467	100%
Other income and expense, net	(1,602)	38,859	(40,461)	-104%
Other income (expense)	(92,210)	42,449	(134,659)	-317%
Loss before income tax expense	(359,593)	(2,018,103)	1,658,510	-82%
Income tax expense	(289)	(33,479)	33,190	-99%
NET LOSS	\$ (359,882)	\$ (2,051,582)	\$ 1,691,700	-82%

At the end of fiscal 2008 and the first half of fiscal 2009, management restructured the entire Company and decreased its employee base by 35% and reduced its usage of outside consultants as part of its overall plan to reduce costs to better align them with the Company's current revenues. Therefore, fiscal 2010 expenses for consulting fees and employment related expenses such as wages, commissions, bonuses, payroll taxes and health benefits were and are expected to be sharply lower than fiscal 2009 expenses, especially in Q1 and Q2.

### Revenues

Software revenue is comprised of hosting, license and maintenance fees. Software revenue decreased during the three months ended August 31, 2009 (Q1 FY2010) compared to the three months ended August 31, 2008 (Q1 FY2009) primarily due to lower subscriptions as a result of us discontinuing support on old software versions.

Professional services revenues decreased in Q1 FY2010 due to less consulting for existing customer upgrades or specialization work and no new customers in Q1 FY2010 compared to Q1 FY2009.

Rewards revenues remained consistent between the periods.

Career Networks revenues decreased in Q1 FY2010 primarily due to less employer and recruiter advertising and economic conditions that negatively affected deals in the recruiting and career transition services segment of the business along with less availability of financing for its customers. Additionally, we spent less on marketing and advertising and as a result received less leads on which to convert to revenues in Q1 FY2010. We have implemented a more targeted approach and alternative financing terms for our career transition clients and as a result believe that the Q2 FY2010 revenues will begin to improve over Q1.

### **Cost of Revenues and Gross Profit**

Software and Professional Services cost of revenues decreased in amount and as a percentage of sales in Q1 FY2010 primarily as a result of reductions in spending by management to control costs. As a result gross profit improved to 92% in Q1 FY2010 compared to 89% in Q1 FY2009.

Rewards cost of revenues decreased in amount and as a percentage of sales during Q1 FY2010 resulting in an improved gross profit by four percentage points from approximately 25% in Q1 FY2009 to 29% in Q1 FY2010. Gross profit on our rewards business is driven primarily by the mix of products redeemed by the customers and results typically range between 20%-30%.

Career Networks cost of revenues decreased in amount in Q1 FY2010 due to the reduction in revenue levels, but gross profit improved slightly to 94% in Q1 FY2010 compared to 93% in Q1 FY2009.

### **Selling and Marketing Expense**

Consulting and employment related expenses declined in Q1 FY2010 by approximately \$640,000 compared to Q1 FY2009 as a result of the restructuring. The additional decrease was due primarily to less trade shows, marketing and advertising programs in Q1 FY2010.

### **General and Administrative Expense**

Consulting and employment related expenses declined in Q1 FY2010 by approximately \$456,000 compared to Q1 FY2009 as a result of the restructuring. Non-cash stock compensation expense decreased by approximately \$59,000 due to less options outstanding. Additionally, we reduced our space occupancy costs and insurance costs approximately \$115,000 by changing or eliminating office space in three locations in Q1 FY2010 compared to Q1 FY2009. Telephone, travel and other administrative expenses also declined due to fewer employees and due to the cancellation and consolidation of contracts in Q1 FY2010.

### **Research and Development Expense**

Consulting and employment related expenses declined in Q1 FY2010 by approximately \$735,000 compared to Q1 FY2009 as a result of the restructuring. Additionally, we reduced our space occupancy costs and insurance costs approximately \$99,000 by changing or eliminating office space in three locations in Q1 FY2010 compared to Q1 FY2009.

### **Amortization and Depreciation Expense**

Amortization expense decreased by nearly \$118,000 in the Q1 FY2010 compared to Q1 FY2009 due to certain acquired intangible assets becoming fully amortized in prior years. Without additional business acquisitions, we are not expecting to incur any additional amortization costs during fiscal 2010. Therefore, fiscal 2010 expense will be significantly less than fiscal 2009. Depreciation expense also decreased by approximately \$81,000 due to many of our fixed assets becoming fully depreciated.

### **Interest Income and Expense, Net**

On August 29, 2008, we entered into an exchange agreement that provided for the exchange of \$19,000,000 Special Warrants and Additional Warrants indexed to 3,800,000 shares of common stock, issued August 3, 2007 ("Old Warrants"), for \$19,147,191 in Face Value of Senior Secured Notes (collectively, the "Notes") and newly issued warrants indexed to 3,800,000 shares of common stock ("New Warrants") (the "Exchange Transaction"). Financing costs of \$147,191 incurred by the holders of the Notes ("Holders") are included in the face value of the Notes. Interest on the Notes accrues at an annual rate of 7% until August 29, 2009 and then 12% per year thereafter. The Notes and the embedded put derivative

were valued in accordance with FAS No. 157 using multiple, probability-weighted cash flow outcomes at credit-risk adjusted market rates. The fair value of the Notes is being accreted to the Face Value including accrued interest of \$22,835,685 until August 29, 2010 through interest expense using the effective interest method. Interest expense on the Notes was \$509,151 during Q1 FY2010.

We also incurred an additional net interest expense of \$7,774 during Q1 FY2010 compared to net interest income of \$3,590 during Q1 FY2009. Net interest expense relates primarily to interest paid on capital leases and other financing transactions net of any interest income earned during the periods.

### **Change in Fair Value of Warrants and Derivative**

The Notes also contain a contingent put reflected in the contractual rights of default. Upon the occurrence of an event of default, as defined in the Notes, a Holder may require us to redeem all or a portion of such Holder's Note at a price equal to 110% of the sum of the principal amount of the Note, accrued and unpaid interest and late fees, if any, to be redeemed. Under FAS No. 133, "Accounting for Derivative Financial Instruments and Hedging Activities," the risks of equity are inconsistent with the risks of the debt host and, therefore, embedded put derivatives such as these require bifurcation and separate classification at fair value. The (\$27,333) change in the fair value of the embedded put derivative from \$493,693 on May 31, 2009 to \$521,026 on August 31, 2009 is recorded as an expense in the Statements of Operations and Comprehensive Loss during Q1 FY2010.

On June 1, 2009, the Company adopted EITF 07-05 which required it to begin accounting for the New Warrants as a liability due primarily to the reset provisions of the warrant in the event of lower priced financing transactions. Therefore, they were reclassified out of equity to a liability classification as of June 1, 2009 via a cumulative effect adjustment (see Warrant Liability under Note 1). The \$450,800 change in the fair value of the New Warrants from \$876,400 on June 1, 2009 to \$425,600 on August 31, 2009 is recorded as income in the Statements of Operations and Comprehensive Loss during Q1 FY2010. Therefore, the net fair value change of all instruments during Q1 FY2010 was recorded as income of \$423,467.

### **LIQUIDITY AND CAPITAL RESOURCES**

As of August 31, 2009, we have approximately \$1,068,000 in cash and cash equivalents. Working capital, which represents current assets less current liabilities, was negative \$24.9 million. This is primarily the result of the fair value of our senior secured notes payable (the "Notes") and a related embedded put derivative on the transaction showing as current as a result of our default on the Notes on May 22, 2009 due to the Company's suspension of trading on the NASDAQ Stock Market as a result of its stockholders deficit. The suspension constituted an event of default under the Notes and thereby entitled each Holder of the Notes to require the Company to redeem all or a portion of the Holder's Note at a price equal to 110% of the sum of the principal amount of the Note, accrued and unpaid interest and late fees, if any. Additionally, as a result of the event of default, the interest rate under each Note was increased by 5% in addition to the contractual rate of interest due.

In August 2009, we signed a term sheet with the Holders, whereby the Holders agreed to restructure the Notes. The term sheet provides that the Holders would exchange the Notes and the accrued interest thereon (approximately \$20.7 million as of August 31, 2009) into \$9.5 million of new senior secured notes with the balance as convertible notes. The proposed new notes would accrue interest at a rate of 9.5% per annum and have a maturity date of July 31, 2012. The Company and the Holders are negotiating the final terms of the refinancing documents and expect to close the transaction during the Company's second fiscal quarter ending November 30, 2009.

Our ability to continue as a going concern depends primarily upon the successful refinancing or modification of our Notes with the existing Holders and other parties as well as our ability to generate positive cash flows from operations. There can be no assurance that the Company will be successful in its negotiations or that the terms of any such refinancing or conversions will not result in the issuance, or potential issuance, of a significant amount of equity securities that will cause substantial dilution to the Company's stockholders. If the Company is not successful in refinancing the Notes or in otherwise entering into a financing, sale, or business transaction that infuses sufficient cash resources into the Company in the near future, any collection actions by the Holders could have a material adverse affect on the liquidity and financial condition of the Company and its ability to secure additional financing and continue as a going concern.

Due to significant reductions in operating expenses in the fourth quarter of fiscal 2008 and throughout fiscal 2009, management believes the current liquidity will be sufficient to meet its anticipated working capital and capital expenditure requirements upon the refinancing of the Notes. The current operating loss is the result of current economic conditions and is a reflection of the overall health of the economy as a whole. As it relates to the Career Networks segment of the business, management believes that the career transition services will gain strength with new programs implemented at the end of the first quarter of fiscal 2010. Based on an analysis of our current contracts, forecasted new business, our current backlog and current expense level, management believes the Company will meet its cash flow needs for fiscal 2010 assuming the successful refinancing of the Notes. If these measures fall short, management will consider additional cost savings measures, including cutting back product development initiatives, further reducing general and administrative expenses and reducing sales and marketing expenditures. We recognize that there are no assurances that the Company will be successful in meeting its cash flow requirements, however, management is confident that, if necessary, there are other alternatives available to fund operations and meet cash requirements during fiscal 2010.

To the extent that existing cash and cash equivalents, and cash from operations, are insufficient to fund our future activities, we may need to raise additional funds through public or private equity or debt financing. We may enter into agreements or letters of intent with respect to potential investments in, or acquisitions of, complementary businesses, applications or technologies in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

## **CRITICAL ACCOUNTING POLICIES**

We believe that the following critical accounting policies affect our more significant estimates and judgments used in preparation of our consolidated financial statements. Management makes estimates and assumptions that affect the value of assets and the reported revenues. Changes in assumptions used would impact our financial position and results. Our significant estimates include the allowance for trade receivables, valuation of goodwill, valuation of derivative financial instruments, valuation of deferred taxes, and valuation of compensation expense on stock-based awards. Although we believe that these estimates are reasonable, actual results could differ from those estimates given a change in conditions or assumptions that have been consistently applied.

Management has discussed the selection of critical accounting policies and estimates with our Board of Directors, and the Board of Directors has reviewed our disclosure relating to critical accounting policies and estimates in this quarterly report on Form 10-Q. The critical accounting policies used by management and the methodology for its estimates and assumptions are as follows:

### **Revenue Recognition**

The Company derives revenue from various sources including the following: subscription and hosting fees; licensing of software and related maintenance fees; professional services related to software implementation, customization and training; sale of products and tickets through the Company's employee rewards software module; career transition services; recruitment research services; and, applicant sourcing.

In general, the Company recognizes revenue when all of the revenue recognition criteria are met, which is typically when:

- evidence of an arrangement exists;
- services have been provided or goods have been delivered;
- the price is fixed or determinable; and
- collection is reasonably assured.

The Company primarily provides various HCM software applications as an on-demand application service and also enters into the sale of license agreements. Revenue is generated through a variety of contractual arrangements.

Subscription and hosting fees and software maintenance fees are billed in advance on a monthly, quarterly or annual basis. Amounts that have been invoiced are recorded in accounts receivable and in deferred revenue or revenue, depending on whether the revenue recognition criteria have been met. Quarterly and annual payments are deferred and recognized monthly over the service period on a straight-line basis. Set up fees are deferred and recognized monthly on a straight-line basis over the contractual lives of the customer.

Subscription revenues and hosting fees consist of fees from customers accessing our on-demand application service. The Company follows the provisions of SEC Staff Accounting Bulletin No. 104, *Revenue Recognition* and Emerging Issues Task Force Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. For revenue arrangements with multiple deliverables, the Company allocates the total customer arrangement to the separate units of accounting based on their relative fair values, as determined by the price of the undelivered items when sold separately. Professional services included in an application services arrangement with multiple deliverables are accounted for separately when these services have value to the customer on a standalone basis, and there is objective and reliable evidence of fair value of each undeliverable item of the arrangement. When accounted for separately, revenues are recognized as the services are rendered.

License revenues consist of fees earned from the granting of both perpetual and term licenses to use the software products. The Company recognizes revenue from the sale of software licenses in accordance with American Institute of Certified Public Accountants ("AICPA") Statement of Position ("SOP") No. 97-2, *Software Revenue Recognition*, and SOP No. 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*, when all of the following conditions are met: a signed contract exists; the software has been shipped or electronically delivered; the license fee is fixed or determinable; and the Company believes that the collection of the fees is reasonably assured. License revenue is recorded upon delivery with an appropriate deferral for maintenance services, if applicable, provided all of the other relevant conditions have been met. The total fee from the arrangement is allocated based on Vendor Specific Objective Evidence ("VSOE") of fair value of each of the undelivered elements. Maintenance agreements are typically priced based on a percentage of the product license fee and are either multi-year or have a one-year term, renewable annually. VSOE of fair value for maintenance is established based on the stated renewal rates. Services provided to customers under maintenance agreements include technical product support and unspecified product upgrades. VSOE of fair value for the professional service element is based on the standard hourly rates the Company charges for services when such services are sold separately.

Source code revenue is generated by sales in small markets that we do not typically target. The sales are for old versions of specific applications or products that we no longer support or sell. As such, future earnings are not affected by these sales. The Company recognizes revenue when all of the revenue recognition criteria are met, which is typically when the services have been completed.

Professional services revenue is generated from implementation of software applications and from customer training, customization and general consulting. In addition, revenue is generated from technical support not included in the software maintenance. The majority of professional services revenue is billed based on an hourly rate and recognized on a monthly basis as services are provided. For certain contracts which involve significant implementation or other services which are essential to the functionality of the software and which are reasonably estimable, the license and implementation services revenue is recognized using contract accounting, as prescribed by SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. Revenue is recognized over the period of each implementation using the percentage-of-completion method. Labor hours incurred is used as the measure of progress towards completion, and management believes its estimates to completion are reasonably dependable. A provision for estimated losses on engagements is made in the period in which the losses become probable and can be reasonably estimated.

One of the software applications offered by the Company allows customers to offer rewards, employee recognition and benefits in an effort to promote their employee retention. The Company generates subscription revenues from the customer. In addition, the Company generates revenue from the sale of products and tickets to the customers' employees through a website. The Company recognizes revenue when all of the revenue recognition criteria are met, which is typically when the goods are shipped and title has transferred.

For career transition services, the Company bills the client 50% when the assignment starts and the remaining 50% when the assignment is completed or upon a later date as agreed. The Company recognizes revenue when all of the revenue recognition criteria are met, which is typically when services have been completed.

For applicant sourcing services, the Company bills its clients in advance on a monthly, quarterly and annual basis. The Company recognizes revenue when all of the revenue recognition criteria are met, which is typically on a straight-line basis as services have been completed. Unrecognized revenue is included in deferred revenue.

As described above, the Company defers certain revenues received and recognizes them ratably over the applicable term of service. If the revenue is expected to be recognized within the following twelve months, it is classified as a current liability

on the accompanying consolidated balance sheets. If the revenue is expected to be recognized over a period longer than 12 months then the portion of revenue expected to be recognized greater than 12 months is classified as a long-term liability.

### **Allowance for Doubtful Accounts**

We perform ongoing credit evaluations of our accounts receivable balances. Based on historical experience, we evaluate the accounts for potential uncollectible amounts based on a specific identification methodology and record a general reserve for all remaining balances. Based on the age of the receivable, cash collection history and past dilution in the receivables, we make an estimate of our anticipated bad debt. Based on this analysis, we reserved \$1,072,458 and \$928,430 for doubtful accounts at August 31, 2009 and May 31, 2009, respectively. We believe that this estimate is reasonable, but there can be no assurance that our estimate will not change given a change in economic conditions or business conditions within our industry, our individual customer base or our Company. Any adjustments to this account are reflected in the accompanying statements of operations and comprehensive loss as a general and administrative expense. Bad debt expense for the first quarter of fiscal 2010 was \$152,034 compared to \$168,608 in the first quarter of fiscal 2009.

### **Goodwill**

We test goodwill for impairment on an annual basis or as needed if circumstances arise that reduce the value of our reporting units below the carrying value. We compare the fair value of each reporting unit to its carrying amount (including goodwill) for our impairment evaluation. Our business segments are considered reporting units for goodwill impairment testing. Goodwill is considered to be impaired if the carrying value of a reporting unit exceeds its fair value. If goodwill is considered to be impaired, the loss that is recognized is equal to the amount that the carrying value of the reporting unit goodwill exceeds the implied fair value of that goodwill.

There are judgments and estimates built into our fair value analysis, including future cash flow projections, the discount rate representing innate risk in future cash flows, market valuation, strategic operation plans and our interpretation of current economic indicators. Changes in any of the underlying assumptions will cause a change in the results, which could lead to the fair value of one or more of the reporting units to be worth less than the current carrying amounts. In addition to a change in market and economic conditions or our strategic plans, the possibility exists that our conclusions could change which would result in a material negative effect on both our financial position and results of operations.

While management has a plan to return the Company's business fundamentals to levels that support the book value per common share, there is no assurance that the plan will be successful, or that the market price of the common stock will increase to such levels in the foreseeable future and the Company may have to recognize an impairment of all, or some portion of, its goodwill and other intangible assets. There is no assurance that: (1) valuation multiples will not decline, (2) discount rates will not increase or (3) the earnings, book values or projected earnings and cash flows of the Company's individual reporting segments will not decline. Accordingly, an impairment charge to goodwill and other intangible assets may be required in the foreseeable future if the book equity value exceeds the estimated fair value of the enterprise or of an individual segment.

### **Derivative Financial Instruments**

Our Senior Secured Notes contain a contingent put reflected in the contractual rights of default. Under these provisions, the Holder has the right to put the Notes back to the Company for 110% of face value in the event of certain equity-indexed defaults, such as listing failure and non-delivery of common shares issuable upon exercise of certain warrants. Under FAS No. 133, "*Accounting for Derivative Financial Instruments and Hedging Activities*," the risks of equity are inconsistent with the risks of the debt host and, therefore, embedded put derivatives such as these require bifurcation and separate classification at fair value. The embedded put derivative and certain Company issued warrants are recorded at fair value, marked-to-market at each reporting period and classified in the Company's balance sheet as a separate line item.

### **Deferred Taxes**

We apply significant judgment in recording deferred tax assets, which primarily are the result of loss carry forwards of companies that we acquired and loss carry forwards internally generated. In addition, we make certain assumptions about if and when these deferred tax assets will be utilized. These determinations require estimates of future profits to be forecasted. The utilization of the Company's net operating loss carry forwards may be limited in any given year under certain circumstances. Events which may affect the Company's ability to utilize these carry forwards include, but are not limited to, future profitability, cumulative stock ownership changes of 50% or more over a three-year period, as defined by

section 382 of the Internal Revenue Code, and the timing of the utilization of the tax benefit carry forwards. Actual results may differ from amounts estimated.

### **Valuation of Non-Cash Stock-Based Compensation**

On June 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standard (“FAS”) No. 123 (revised 2004) No. 123R, “Share-Based Payments” (“FAS No. 123R”) which requires it to recognize expense related to the fair value of stock-based compensation awards. Stock-based compensation expense for all stock-based compensation awards granted on or subsequent to June 1, 2006 is based on the grant date fair value estimated in accordance with the provisions of FAS No. 123R. Compensation expense for stock option awards is recognized on a straight-line basis over the requisite service period of the award.

We use the Black-Scholes option-pricing model to value our stock option grants under FAS No. 123R. FAS No. 123R also requires us to estimate forfeitures in calculating the expense related to stock-based compensation, and it requires us to reflect cash flows resulting from excess tax benefits related to those options as a cash inflow from financing activities rather than as a reduction of taxes paid.

The assumptions in the table presented below were used to calculate the fair-value of share-based payment awards using the Black-Scholes option pricing model, which values options based on the stock price at the grant date, the expected life of the option, the estimated volatility of the stock, expected dividend payments, and the risk-free interest rate over the expected life of the option. The dividend yield was calculated by dividing the current annualized dividend by the option exercise price of each grant. The expected volatility was determined considering the Company’s historical stock prices for the fiscal year the grant occurred and prior fiscal years for a period equal to the expected life of the option. The risk-free rate represents the US Treasury bond rate with maturity equal to the expected life of the option. The expected life of the option was estimated based on the exercise history of previous grants.

	<u>Three Months Ended</u>	
	<u>August 31, 2009</u>	<u>August 31, 2008</u>
Expected volatility	169%-171%	68%
Expected dividend yield	0%	0%
Expected term (in years)	3.45	3.50
Risk-free interest rate	2.46%-2.71%	3.43%
Forfeiture rate	30%	0%

### **RECENT ACCOUNTING PRONOUNCEMENTS**

See Note 1 in the Unaudited Consolidated Financial Statements for information concerning recent accounting pronouncements.

#### **ITEM 4T. CONTROLS AND PROCEDURES**

Disclosure controls are controls and procedures designed to reasonably ensure that information required to be disclosed in our reports filed under the Exchange Act, such as this report, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls include controls and procedures designed to reasonably ensure that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure. Because of its inherent limitations, internal control over financial reporting is not intended to provide absolute assurance that a misstatement of the Company's financial statements would be prevented or detected. Furthermore, the Company's controls and procedures could be circumvented by the individual acts of some persons, by collusion or two or more people or by management override of the control. Misstatements due to error or fraud may occur and not be detected on a timely basis.

In the Annual Report on Form 10-K for the fiscal year ended May 31, 2009, we noted that we had identified a material weakness in our information technology (IT) controls because of our inability to test the information technology controls due to the restructuring of our IT department and relocation and consolidation of our corporate headquarters in Canada and Florida to new facilities at the end of our fiscal year. As of August 31, 2009 under the supervision of and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934. Based upon our evaluation, management concluded that our internal control over financial reporting was not effective as of August 31, 2009 because of our continued inability to test the information technology controls at our new corporate headquarters at such date. In connection with this evaluation, management identified no other changes in our internal control over financial reporting that occurred during the most recent fiscal quarter that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

A material weakness is a control deficiency that results in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis by employees in the normal course of their assigned functions. The Company is in the process of executing its plan to mitigate this material weakness including the restructuring of key IT personnel and consolidation of IT responsibility. Despite the existence of this material weakness, we believe our consolidated financial statements in this Quarterly Report on Form 10-Q fairly present, in all material respects, our financial condition as of August 31, 2009 and May 31, 2009, and our consolidated results of operations and cash flows for the three months ended August 31, 2009 and 2008, in conformity with U.S. generally accepted accounting principles.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

We are involved in claims, which arise in the ordinary course of business. In the opinion of management, we have made adequate provision for potential liabilities, if any, arising from any such matters. However, litigation is inherently unpredictable, and the costs and other effects of pending or future litigation, governmental investigations, legal and administrative cases and proceedings (whether civil or criminal), settlements, judgments and investigations, claims and changes in any such matters, and developments or assertions by or against us relating to intellectual property rights and intellectual property licenses, could have a material adverse effect on our business, financial condition and operating results. See Note 5- *Contingencies* in the Unaudited Consolidated Financial Statements for further discussion of litigation that may be material to our business.

### ITEM 1A. RISK FACTORS

In addition to the information set forth under Item 1A of Part I to our Annual Report on Form 10-K for the year ended May 31, 2009, you should carefully consider the following factors, which could have a material adverse effect on our results of operations, financial condition, cash flows, business or the market for our common shares. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial may also materially adversely affect our business, financial condition and future results of operations. We cannot assure you that we will successfully address any of these risks or address them on a continuing basis.

**We have limited operating funds, and our ability to continue as a going concern is dependent upon our ability to obtain additional capital to operate the business.**

The opinion of our independent registered public accountants on the audited financial statements as of and for the year ended May 31, 2009 contained an explanatory paragraph regarding substantial doubt about our ability to continue as a going concern. We have incurred substantial losses in recent years and months and, as a result, have a stockholders deficit of \$7,023,265 as of August 31, 2009. Losses for the three months ended August 31, 2009 were \$359,882 and losses for the years ended May 31, 2009 and 2008 were \$4,856,356 and \$52,616,875, respectively.

As of August 31, 2009, we have approximately \$1,068,000 in cash and cash equivalents. Working capital, which represents current assets less current liabilities, was negative \$24.9 million. This is primarily the result of the fair value of our senior secured notes payable (the "Notes") and a related embedded put derivative on the transaction showing as current as a result of our default on the Notes on May 22, 2009 due to the Company's suspension of trading on the NASDAQ Stock Market as a result of its stockholders deficit. The suspension constituted an event of default under the Notes and thereby entitled each Holder of the Notes to require the Company to redeem all or a portion of the Holder's Note at a price equal to 110% of the sum of the principal amount of the Note, accrued and unpaid interest and late fees, if any. Additionally, as a result of the event of default, the interest rate under each Note was increased by 5% in addition to the contractual rate of interest due.

In August 2009, we signed a term sheet with the holders of the Notes ("Holders"), whereby the Holders agreed to restructure the Notes. The term sheet provides that the Holders would exchange the Notes and the accrued interest thereon (approximately \$20.7 million as of August 31, 2009) into \$9.5 million of new senior secured notes with the balance as convertible notes. The proposed new notes would accrue interest at a rate of 9.5% per annum and have a maturity date of July 31, 2012. The Company and the Holders are negotiating the final terms of the refinancing documents and expect to close the transaction during the Company's second fiscal quarter ending November 30, 2009.

Our ability to continue as a going concern depends primarily upon the successful refinancing or modification of our Notes with the existing Holders and other parties as well as our ability to generate positive cash flows from operations. There can be no assurance that the Company will be successful in its negotiations or that the terms of any such refinancing or conversions will not result in the issuance, or potential issuance, of a significant amount of equity securities that will cause substantial dilution to the Company's stockholders. If the Company is not successful in refinancing the Notes or in otherwise entering into a financing, sale, or business transaction that infuses sufficient cash resources into the Company in the near future, any collection actions by the Holders could have a material adverse affect on the liquidity and financial condition of the Company and its ability to secure additional financing and continue as a going concern.

Our ability to obtain financing depends on a number of factors, including our ability to generate positive cash flow from operations, the amount of our cash reserves, the amount and terms of our existing debt arrangements, the availability of sufficient collateral and the prospects of our business. If financing is not available when required or is not available on acceptable terms, it may impair our ability to:

- fund current operations;
- keep up with technological advances;
- pursue acquisition opportunities;
- develop product enhancements;
- make capital expenditures;
- respond to business opportunities;
- address competitive pressures or adverse industry developments; or
- withstand economic or business downturns.

## **ITEM 6. EXHIBITS**

### **EXHIBITS**

The following Exhibits are filed as part of this Form 10-Q:

<b><u>Exhibit No</u></b>	<b><u>Exhibit Description</u></b>
*31.1	Certification of Chief Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes Oxley Act of 2002.
*31.2	Certification of Chief Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes Oxley Act of 2002.
*32.1	Certifications of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002.

\* Filed herewith.

Our internet website address is [www.workstreaminc.com](http://www.workstreaminc.com). We provide free access to various reports that we file with or furnish to the United States Securities and Exchange Commission through our website, as soon as reasonably practicable after they have been filed or furnished. These reports include, but are not limited to, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports. Our SEC reports can be accessed through the investor relations section of our website, or through [www.sec.gov](http://www.sec.gov). Information on our website does not constitute part of this 10-Q report or any other report we file or furnish with the SEC.

## SIGNATURES

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

Workstream Inc.  
(Registrant)

DATE: October 15, 2009

By: /s/ Steve Purello  
Steve Purello  
President and Chief Executive Officer  
(Principal Executive Officer)

DATE: October 15, 2009

By: /s/ Michael Mullarkey  
Michael Mullarkey  
Acting Chief Financial Officer  
(Principal Financial Officer)

**EXHIBIT 31.1**

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT  
TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Steve Purello, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Workstream Inc.:
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

DATE: October 15, 2009

By: /s/ Steve Purello  
Steve Purello  
President and Chief Executive Officer  
(Principal Executive Officer)

**EXHIBIT 31.2**

**CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT  
TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Michael Mullarkey, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Workstream Inc.:
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

DATE: October 15, 2009

By: /s/ Michael Mullarkey  
Michael Mullarkey  
Acting Chief Financial Officer  
(Principal Financial Officer)

**EXHIBIT 32.1**

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the accompanying Annual Report of Workstream Inc. (the "Company") on Form 10-Q for the period ended August 31, 2009, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, Steve Purello, Chief Executive Officer of the Company, and Michael Mullarkey, Acting Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to their respective knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

DATE: October 15, 2009

By: /s/ Steve Purello  
Steve Purello  
President and Chief Executive Officer  
(Principal Executive Officer)

DATE: October 15, 2009

By: /s/ Michael Mullarkey  
Michael Mullarkey  
Acting Chief Financial Officer  
(Principal Financial Officer)