
**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 September 30, 2005

OR

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

For the transition period from _____ to _____

Commission File No. 000-30901

SUPPORTSOFT, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

94-3282005
(I.R.S. Employer
Identification No.)

575 Broadway
Redwood City, CA 94063
(Address of Principal Executive Offices)
(Zip Code)

Registrant's Telephone Number, Including Area Code: (650) 556-9440

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 is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).
Yes No

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

On November 3, 2005, 43,324,960 shares of the Registrant's Common Stock, \$0.0001 par value, were outstanding.

SUPPORTSOFT, INC.
FORM 10-Q
QUARTERLY PERIOD ENDED SEPTEMBER 30, 2005
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PART I. FINANCIAL INFORMATION
ITEM 1: FINANCIAL STATEMENTS
SUPPORTSOFT, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	September 30, 2005	December 31, 2004
	<u>(unaudited)</u>	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 19,183	\$ 16,509
Short-term investments	97,512	103,832
Accounts receivable, net	12,890	9,594
Prepays and other current assets	2,732	3,523
	<u>132,317</u>	<u>133,458</u>
Total current assets		
Property and equipment, net	1,441	1,347
Goodwill	9,792	9,792
Purchased intangible assets, net	4,267	5,084
Other assets	864	524
	<u>148,681</u>	<u>150,205</u>
Total assets	\$ 148,681	\$ 150,205
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 828	\$ 344
Accrued compensation	1,777	2,756
Other accrued liabilities	2,539	2,607
Deferred revenue	9,938	14,431
	<u>15,082</u>	<u>20,138</u>
Total current liabilities		
Deferred revenue—long-term portion	1,525	2,210
Commitments and contingencies		
Stockholders' equity:		
Common stock	4	4
Treasury stock	(922)	—
Additional paid-in capital	195,887	193,851
Accumulated other comprehensive loss	(795)	(618)
Accumulated deficit	(62,100)	(65,380)
	<u>132,074</u>	<u>127,857</u>
Total stockholders' equity		
Total liabilities and stockholders' equity	\$ 148,681	\$ 150,205

See accompanying notes.

SUPPORTSOFT, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
				(restated)
Revenue:				
License fees	\$ 5,404	\$ 5,741	\$23,751	\$28,446
Services	7,582	6,499	22,369	16,393
Total revenue	12,986	12,240	46,120	44,839
Costs and expenses:				
Cost of license fees	123	46	440	209
Cost of services	3,530	2,500	10,640	7,078
Amortization of purchased intangible assets	272	92	816	92
Research and development	2,700	2,290	8,535	6,967
Sales and marketing	5,304	5,446	18,369	17,500
General and administrative	2,128	1,660	6,387	4,459
In-process research and development	—	1,618	—	1,618
Total costs and expenses	14,057	13,652	45,187	37,923
Income (loss) from operations	(1,071)	(1,412)	933	6,916
Interest income and other, net	909	599	2,523	1,785
Income before income taxes	(162)	(813)	3,456	8,701
Income tax benefit (expense)	77	481	(176)	(608)
Net income (loss)	\$ (85)	\$ (332)	\$ 3,280	\$ 8,093
Basic net income (loss) per share	\$ (0.00)	\$ (0.01)	\$ 0.08	\$ 0.19
Shares used in computing basic net income (loss) per share	43,001	42,533	42,914	42,291
Diluted net income (loss) per share	\$ (0.00)	\$ (0.01)	\$ 0.07	\$ 0.18
Shares used in computing diluted net income (loss) per share	43,001	42,533	44,629	45,778

See accompanying notes.

SUPPORTSOFT, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Nine Months Ended September 30,	
	2005	2004 (restated)
Operating Activities:		
Net income	\$ 3,280	\$ 8,093
Adjustments to reconcile net income to net cash provided by/(used in) operating activities:		
Depreciation and amortization	845	689
Stock compensation and amortized deferred compensation	—	183
Amortization of purchased intangible assets	817	92
In-process research and development	—	1,618
Other	154	492
Changes in assets and liabilities:		
Accounts receivable	(3,296)	4,098
Prepays and other current assets	791	(1,313)
Other long-term assets	(340)	47
Accounts payable	484	225
Accrued compensation	(979)	(73)
Other accrued liabilities	(68)	2,839
Deferred revenue	(5,178)	(6,717)
Net cash provided by/(used in) operating activities	(3,490)	10,273
Investing Activities:		
Purchases of property and equipment	(939)	(743)
Other assets	—	62
Purchases of short-term investments	(71,757)	(113,614)
Sales and maturities of short-term investments	77,746	108,853
Acquisition, net of cash acquired	—	(17,607)
Net cash provided by/(used in) investing activities	5,050	(23,049)
Financing Activities:		
Proceeds from issuances of common stock	2,036	3,863
Repurchase of common stock	(922)	—
Net cash provided by financing activities	1,114	3,863
Net increase/(decrease) in cash and cash equivalents	2,674	(8,913)
Cash and cash equivalents at beginning of period	16,509	22,208
Cash and cash equivalents at end of period	\$ 19,183	\$ 13,295
Supplemental schedule of cash flow information		
Income taxes paid	\$ 114	\$ 70

See accompanying notes.

SUPPORTSOFT, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

(1) Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of SupportSoft, Inc. (the “Company” or “SupportSoft”) and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated upon consolidation. The balance sheet as of September 30, 2005 and the statements of operations for the three and nine months ended September 30, 2005 and 2004 and cash flows for the nine months ended September 30, 2005 and 2004 are unaudited. In the opinion of management, these financial statements reflect all adjustments (consisting of normal recurring adjustments) that are necessary for a fair presentation of the results for and as of the periods shown. The results of operations for such periods are not necessarily indicative of the results expected for the full fiscal year or for any future period. The condensed consolidated financial statement information as of December 31, 2004 is derived from audited financial statements as of that date. These financial statements should be read with the consolidated financial statements and related notes included in the Company’s Annual Report on Form 10-K, filed with the Securities and Exchange Commission on March 16, 2005.

Adjustments to Previously Reported Financial Information

In December 2004, as part of the Company’s year-end closing procedures and in conjunction with the audit of the Company’s year-end financial statements, we identified adjustments related to the first and second quarter of fiscal 2004. In the first quarter of 2004, an adjustment related to the non-cash stock-based compensation for two terminated employees increased research and development expense by \$152,000 and sales and marketing expense by \$31,000, decreased income from operations by \$183,000 and decreased diluted earnings per share by \$0.01. In the second quarter of 2004, an adjustment related to capitalized service costs that should have been expensed increased cost of services by \$203,000, decreased income from operations by \$203,000 and decreased basic and diluted earnings per share by \$0.01. The cumulative impact of these adjustments for the nine months ended September 30, 2004 was to decrease income from operations by \$386,000 and decrease basic and diluted earning per share by \$0.01.

Use of Estimates

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and the accompanying notes. Actual results could differ materially from these estimates.

Financial Instruments

Estimated fair values of financial instruments are based on quoted market prices. The following is a summary of cash and available-for-sale securities at September 30, 2005 (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Cash	\$ 5,708	\$ —	\$ —	\$ 5,708
Money market funds	857	—	—	857
Commercial paper	12,622	—	(4)	12,618
Federal agencies	5,000	—	(8)	4,992
Municipal bonds	—	—	—	—
Corporate bonds	23,868	—	(123)	23,745
Auction backed securities	68,775	—	—	68,775
	<u>\$116,830</u>	<u>\$ —</u>	<u>\$ (135)</u>	<u>\$116,695</u>
Classified as:				
Cash and cash equivalents	\$ 19,187	\$ —	\$ (4)	\$ 19,183
Short-term investments	97,643	—	(131)	97,512
	<u>\$116,830</u>	<u>\$ —</u>	<u>\$ (135)</u>	<u>\$116,695</u>

Revenue Recognition

We recognize revenue in accordance with the American Institute of Certified Public Accountants' (AICPA) Statement of Position ("SOP") 97-2, Software Revenue Recognition, as amended by SOP 98-4 and SOP 98-9. License revenue is recognized when all of the following criteria are met:

- Persuasive evidence of an arrangement exists;
- Delivery has occurred;
- No uncertainties surrounding product acceptance exist;
- Collection is considered probable; and
- The fees are fixed or determinable.

SupportSoft considers all arrangements with payment terms longer than normal not to be fixed or determinable. If the fee is determined not to be fixed or determinable, revenue is recognized as payments become due from the customer.

License revenue is comprised of fees for perpetual and term licenses of our software. Perpetual license revenue is recognized using the residual method described in SOP 98-9 for arrangements in which licenses are sold with multiple elements. We allocate revenues on these licenses based upon the fair value of each undelivered element (for example, undelivered maintenance and support, consulting, and training). The determination of fair value is based upon vendor specific objective evidence (VSOE). VSOE for maintenance and support is determined based upon separate renewals of maintenance and support from customers. VSOE for training and consulting is based upon separate sales of these services to customers. Assuming all other revenue recognition criteria are met, the difference between the total arrangement fee and the amount deferred for each undelivered element is recognized as license revenue. Our perpetual arrangements may include contractual obligations such as rights to unspecified future products which require license revenue to be taken ratably (monthly) over the contract period. In addition, our perpetual arrangements may include payment terms beyond our normal terms, in which case the license revenue is recognized as such payments become due.

Term licenses are sold with maintenance for which SupportSoft does not have VSOE to determine fair value. As a result, license revenue for term licenses is recognized ratably over the duration of the agreement. License fees in the accompanying financial statements includes maintenance for term licenses. We do not allocate maintenance revenue from term licenses to services revenue, as we do not believe there is an allocation methodology that provides a meaningful and supportable allocation between license and maintenance revenues. Services revenue other than maintenance associated with the term licenses are recognized ratably over the period associated with the initial payment, generally one year.

We also recognize license revenue from arrangements with resellers. These arrangements may be either term or perpetual licenses of our software. When term licensing arrangements with resellers include guaranteed minimum amounts due, revenue is recognized ratably over the term of the arrangement commencing when payments become due. When the arrangements do not include guaranteed minimum amounts due but are instead based upon the license of our software through to the end user, revenue recognition commences upon persuasive evidence that the products have been sold to an end user; whether the license revenue is then recognized immediately or ratably depends upon the terms of the arrangements with the reseller. If a reseller is not deemed credit-worthy, revenue is recognized upon cash receipt.

Services revenue is primarily comprised of revenue from professional services, such as maintenance and support, consulting and training. Arrangements that include services are evaluated to determine whether those services are essential to the functionality of other elements of the arrangement. Revenue from non-essential consulting and training services associated with perpetual licenses is generally recognized as the services are performed. When non-essential services are bundled in a term licensing arrangement, revenue from the services is recognized ratably

over the period associated with the initial payment, generally one year. Maintenance and support revenues are recognized over the term of the maintenance and support period which is generally one year. In the event services are considered essential to the functionality of other elements of the arrangement, revenue under the arrangement is recognized using contract accounting.

Concentration of Credit Risk and Significant Customers

Financial instruments that potentially subject SupportSoft to concentrations of credit risk consist principally of cash equivalents, short-term investments and trade accounts receivable. Our investment portfolio is diversified and consists of investment grade securities. Our investment policy limits the amount of credit risk exposure to any one issuer and in any one country except the US. The credit risk in our trade accounts receivable is substantially mitigated by our credit evaluation process, reasonably short collection terms and the fact that the Company sells its products primarily to large organizations in diversified industries. We maintain reserves for potential credit losses and such losses have been within management's expectations.

The following table lists the customers that represented more than 10% of total revenue for the periods indicated:

	% of Total Revenue			
	Three months ended September 30, 2005	Three months ended September 30, 2004	Nine months ended September 30, 2005	Nine months ended September 30, 2004
Customer A	19%	—	11%	—
Customer B	—	—	11%	—
Customer C	—	27%	—	17%
Customer D	—	—	—	13%

Trade Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount. The allowance for doubtful accounts is SupportSoft's best estimate of the amount of probable credit losses in the existing accounts receivable. SupportSoft performs on-going evaluations of its customers' financial condition and generally does not require collateral. SupportSoft maintains reserves for credit losses, and such losses have been within management's expectations. If the financial condition of SupportSoft's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional reserves may be required. At September 30, 2005 and December 31, 2004, the Company had reserves for credit losses of \$264,000 and \$447,000, respectively. At September 30, 2005 one customer accounted for 10% or more of total accounts receivable. This customer accounted for 20% of our total accounts receivable. At December 31, 2004, three different customers each accounted for 10% or more of our total accounts receivable. These three customers, in the aggregate, accounted for approximately 62% of total accounts receivable.

Business Combinations

When we acquire businesses, we allocate the purchase price to tangible assets and liabilities acquired and identifiable intangible assets. Any residual purchase price is recorded as goodwill. We engage independent third-party appraisal firms to assist in determining the fair values of assets acquired and liabilities assumed. Such a valuation requires management to make significant estimates, especially with respect to intangible assets. These estimates are based on historical experience and information obtained from the management of the acquired companies. These estimates can include, but are not limited to, the cash flows that an asset is expected to generate in the future, the appropriate weighted average cost of capital, and the cost savings expected to be derived from acquiring an asset. These estimates are inherently uncertain and unpredictable. In addition, unanticipated events and circumstances may occur which may affect the accuracy or validity of such estimates.

At September 30, 2005, goodwill was \$9.8 million, and other identifiable intangible assets, net were \$4.3 million. We assess the impairment of goodwill annually or more often if events or changes in circumstances indicate that the carrying value may not be recoverable. We assess the impairment of acquired product rights and other identifiable intangible assets whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. An impairment loss would be recognized when the fair value of the asset is less than its carrying amount. SupportSoft has only one operating segment and that segment is its sole reporting unit. Consequently, goodwill is tested for impairment at the entity level.

Management has concluded its annual evaluation for impairment of goodwill as of August 31, 2005 and no impairment was recognized.

Net Income Per Share

Basic and diluted net income (loss) per share are presented in accordance with Statement of Financial Accounting Standards No. 128, "Earnings per Share" ("SFAS 128"), for all periods presented. In accordance with SFAS 128, basic and diluted net loss per share have been computed using the weighted-average number of common shares outstanding during the period, less shares subject to repurchase.

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

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Net income (loss)	\$ (85)	\$ (332)	\$ 3,280	\$ 8,093
Basic:				
Weighted-average shares of common stock outstanding	43,001	42,533	42,914	42,291
Shares used in computing basic net income per share	43,001	42,533	42,914	42,291
Basic net income (loss) per share	\$ 0.00	\$ (0.01)	\$ 0.08	\$ 0.19
Diluted:				
Weighted-average shares of common stock outstanding	43,001	42,533	42,914	42,291
Add: Common equivalent shares outstanding	—	—	1,715	3,487
Shares used in computing diluted net income per share	43,001	42,533	44,629	45,778
Diluted net income (loss) per share:	\$ 0.00	\$ (0.01)	\$ 0.07	\$ 0.18

Stock-Based Compensation

SupportSoft accounts for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), and has adopted the disclosure only alternative of

Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation” (“SFAS 123”). Under APB Opinion No. 25, SupportSoft does not recognize compensation expense with respect to such awards if the exercise price equals or exceeds the fair value of the underlying security on the date of grant and other terms are fixed. Any deferred stock compensation calculated according to APB 25 is amortized over the vesting period of the individual options, generally four years, using the accelerated method. This method provides for expensing of portions of the overall awards at interim dates and results in greater expensing in earlier years than the straight-line method.

For purposes of pro forma disclosures pursuant to SFAS 123 as amended by SFAS 148, the estimated fair value of options and employee stock purchase program shares (“ESPP”) are based on the Black-Scholes valuation model and are amortized to expense over the vesting period of the options using the accelerated method. The effects of applying SFAS 123 for pro forma disclosures may not be representative of the effects on reported net income or loss for future years.

SupportSoft’s pro forma information follows (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income (loss)	\$ (85)	\$ (332)	\$ 3,280	\$ 8,093
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards	(2,005)	(1,940)	(6,060)	(6,192)
Deduct: Total ESPP-based compensation expense determined under the fair value based method for all awards	(56)	(166)	(369)	(498)
Pro forma net income (loss)	\$ (2,146)	\$ (2,438)	\$ (3,149)	\$ 1,403
Basic net income (loss) per share:				
As reported	\$ 0.00	\$ (0.01)	\$ 0.08	\$ 0.19
Pro forma	\$ (0.05)	\$ (0.06)	\$ (0.07)	\$ 0.03
Diluted net income (loss) per share:				
As reported	\$ 0.00	\$ (0.01)	\$ 0.07	\$ 0.18
Pro forma	\$ (0.05)	\$ (0.06)	\$ (0.07)	\$ 0.03

The following assumptions were used:

Employee and Director Stock Options	Three months end September 30,		Nine months end September 30,	
	2005	2004	2005	2004
Risk-free interest rate	4.13%	3.1%	3.86%	2.9%
Expected life (years)	4.0	4.0	4.0	4.0
Volatility	73.3%	77.9%	77.9%	69.6%
Dividend Yield	0.0%	0.0%	0.0%	0.0%

Employee Stock Purchase Plan	Three months end September 30,		Nine months end September 30,	
	2005	2004	2005	2004
Risk-free interest rate	1.8% – 4.0%	1.21% – 2.69%	1.8% – 4.0%	1.05% – 2.69%
Expected life (years)	0.5 – 2.0	0.5 – 2.0	0.5 – 2.0	0.5 – 2.0
Volatility	71.0%	83.0%	75.2%	77.6%
Dividend Yield	0.0%	0.0%	0.0%	0.0%

In December 2004, the FASB issued SFAS No. 123 (revised 2004), “Share-Based Payment” (“SFAS 123R”), which replaces SFAS No.

123, "Accounting for Stock-Based Compensation" (SFAS 123) and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS 123R also amends SFAS No. 95, "Statement of Cash Flows," to require that tax benefits from stock option exercises be classified as a financing activity, instead of an operating activity, on the statement of cash flows. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values, beginning with the first annual period after June 15, 2005. The pro forma disclosures previously permitted under SFAS 123 will no longer be an alternative to financial statement recognition. We are required to adopt SFAS 123R in our first quarter of 2006, beginning January 1, 2006. Under SFAS 123R, we must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for recognizing compensation cost, and the transition method to be used at the date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive option, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, whereas under the retroactive method we would record compensation expense for all prior years. At this time we are unable to quantify the effect of adoption of SFAS 123R. We are evaluating the requirements of SFAS 123R and expect that the adoption of SFAS 123R on January 1, 2006 will have a material effect on SupportSoft's consolidated results of operations and earnings per share.

Warranties and Indemnifications

SupportSoft generally provides a warranty for its software products and services to its customers and accounts for its warranties under the FASB's Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies" ("FAS No. 5"). Warranty periods can vary from customer to customer but our standard warranty period is 90 days. In the event there is a failure of the product in breach of such warranties, SupportSoft generally is obligated to correct the product or service to conform to the warranty provision or, if SupportSoft is unable to do so, the customer is entitled to seek a refund of the purchase price of the product or service. SupportSoft did not provide for a warranty accrual as of September 30, 2005 or December 31, 2004. To date, SupportSoft's product warranty expense has not been significant.

SupportSoft generally agrees to indemnify its customers against legal claims that SupportSoft's software products infringe certain third-party intellectual property rights and accounts for its indemnification obligations under FAS No. 5. To date, SupportSoft has not been required to make any payment resulting from infringement claims asserted against our customers and has not recorded any related accruals.

(2) Comprehensive Income

Statement of Financial Accounting No. 130, "Reporting Comprehensive Income" ("SFAS 130") establishes standards for reporting and displaying comprehensive net income and its components in stockholders' equity. However, it has no impact on our net income as presented in our financial statements. SFAS 130 requires foreign currency translation adjustments and changes in the fair value of available-for-sale securities to be included in comprehensive income.

The following are the components of comprehensive income (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Net income (loss)	\$ (85)	\$ (332)	\$3,280	\$8,093
Net unrealized gain (loss) on available-for-sale securities	38	125	134	(253)
Foreign currency translation gain (loss)	132	(207)	(311)	(133)
Comprehensive income (loss)	\$ 85	\$ (414)	\$3,103	\$7,707

The components of accumulated other comprehensive income relate entirely to translation adjustment gains and losses and unrealized gains and losses on available-for-sale securities and are \$(660,000) and \$(135,000) at September 30, 2005, respectively.

(3) Income Taxes

We recorded an income tax benefit of \$77,000 for the three months ended September 30, 2005 and a provision for income taxes of approximately \$176,000 for the nine months ended September 30, 2005. For the three and nine months ended September 30, 2004, we recorded an income tax benefit of \$481,000 and a provision for income taxes of approximately \$608,000, respectively. The income tax benefit for the three months ended September 30, 2005 reflects a tax benefit on the loss in the quarter at our projected effective tax rate for the year and a benefit from true-ups related to tax returns that were filed in the quarter ended September 30, 2005. The effective tax rate used to record the provision for income taxes in the three and nine months ended September 30, 2005 and the three and nine months ended September 30, 2004 differed from the expected US federal statutory rate primarily due to the utilization of previously unbenefited net operating losses.

As of September 30, 2005, our deferred tax assets are fully offset by a valuation allowance because we expect that it is more likely than not that all deferred tax assets will not be realized in the foreseeable future. The Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 109 "Accounting for Income Taxes," provides for the recognition of deferred tax assets if realization of such assets is more likely than not. Based upon the weight of available evidence, which includes SupportSoft's historical operating performance, reported cumulative net losses since inception and difficulty in accurately forecasting our future results, the Company provided a full valuation allowance against its net deferred tax assets. We reassess the need for our valuation allowance on a quarterly basis.

(4) Contingencies

Between December 9, 2004 and January 21, 2005, several purported securities class action suits were filed in the United States District Court for the Northern District of California against the Company, its CEO, Radha R. Basu, and its CFO, Brian M Beattie. These actions were consolidated on March 22, 2005 as *In re SupportSoft, Inc. Securities Litigation*, Civil Action No.: c 04-5222 SI. The consolidated complaint alleges generally violations of certain federal securities laws and seek unspecified damages on behalf of a class of purchasers of the Company's common stock between January 20, 2004 and October 1, 2004. Plaintiffs allege, among other things, that defendants made false and misleading statements concerning the Company's business and guidance for the third quarter 2004, purportedly violating Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. On July 15, 2005, the Court granted our motion to dismiss the Complaint with leave to amend the Complaint. The plaintiffs filed their First Amended Complaint on August 19, 2005. On September 23, 2005, we moved to dismiss the First Amended Complaint and the hearing on this motion is set for November 18, 2005. While we cannot predict with certainty the outcome of the litigation, we believe that the claims against us and our officers are without merit.

In November 2001, a class action lawsuit was filed against us and two of our officers in the United States District Court for the Southern District of New York. The lawsuit alleged that our registration statement and prospectus dated July 18, 2000 for the issuance and initial public offering of 4,250,000 shares of our common stock contained material misrepresentations and/or omissions, related to alleged inflated commissions received by the underwriters of the offering. The defendants named in the lawsuit are SupportSoft, Radha Basu, Brian Beattie, Credit Suisse First Boston Corporation, Bear, Stearns & Co. Inc. and FleetBoston Robertson Stephens Inc. The lawsuit seeks unspecified damages as well as interest, fees and costs. Similar complaints have been filed against 55 underwriters and more than 300 other companies and other individual officers and directors of those companies. All of the complaints against the underwriters, issuers and individuals have been consolidated for pre-trial purposes before U.S. District Court Judge Scheindlin of the Southern District of New York. On June 26, 2003, the plaintiffs announced that a proposed settlement between the issuer defendants and their directors and officers had been reached. As a result of the proposed settlement, which is subject to court approval, we anticipate that our insurance carrier will be responsible for any payments other than attorneys' fees prior to June 1, 2003. At a court conference on March 4, 2004, plaintiffs' executive committee advised the court that the negotiators for plaintiffs and issuers have agreed on the terms of the settlement. During mid-2004, the plaintiffs moved for preliminary approval of the proposed settlement. After full briefing and argument, on February 15, 2005, the court issued an opinion preliminarily approving the proposed settlement, contingent upon modifications being made to one aspect of the proposed settlement—the proposed "bar order". At a further conference on April 13, 2005, the court set a further schedule for submission of documents concerning the form and substance of class notice, and tentatively set a Rule 23 public hearing on the fairness of the proposed settlement for January 9, 2006. On August 31, 2005, the court issued an order preliminarily approving the settlement and setting a public hearing on its fairness for April 24, 2006 (the postponement from January 2006 to April 2006 was because of difficulties in mailing the required notice to class members). On October 27, 2005, the court issued an order making some minor changes to the form of notice to be sent to class members. While we cannot predict with certainty the outcome of the litigation or whether the settlement will be approved, we believe that the claims against us and our officers are without merit.

We are also subject to other routine legal proceedings, as well as demands, claims and threatened litigation, that arise in the normal course of our business. The ultimate outcome of any litigation is uncertain, and either unfavorable or favorable outcomes could have a material negative impact. Regardless of outcome, litigation can have an adverse impact on SupportSoft because of defense costs, diversion of management resources and other factors.

We are required to make periodic filings in the states where we are deemed to have a presence for tax purposes. We have undergone state audits in the past and have paid assessments arising from these audits. To date, such amounts have not been material. We evaluate estimated losses that could arise from similar assessments in accordance with Statement of Financial Accounting Standard No. 5, "Accounting for Contingencies." We consider such factors as the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. An estimated loss is accrued if the information available indicates that it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated.

(5) Reclassifications of Previously Reported Financial Information

We have reclassified certain amounts in the consolidated statement of cash flows for the nine months ended September 30, 2004 to conform to current presentation. Amortization of royalties paid to third-party vendors of \$47,000 have been reclassified from other assets within investing activities to other long-term assets within operating activities for the nine months September 30, 2004.

We have reclassified certain amounts in the consolidated statement of cash flows for the nine months ended September 30, 2004 to conform to current presentation. Market auction municipal bonds of \$26.3 million have been reclassified from cash equivalents to short-term investments at September 30, 2004. Due to this reclassification, net cash used in investing activities increased by \$26.3 million for the nine months ended September 30, 2004.

(6) Capital Stock

On April 27, 2005, the Company's board of directors authorized the repurchase of up to 2,000,000 outstanding shares of the Company's common stock. In the second quarter of 2005, the Company repurchased 192,598 shares of outstanding common stock at a cost of \$922,294 or an average cost of \$4.76 per share, excluding commissions. As of September 30, 2005, the maximum number of shares remaining that can be repurchased under this program was 1,807,402.

(7) Subsequent Events

In October 2005, the Company performed a review of its business operations and realigned its resources and go-to-market strategies to maximize revenue opportunities. This realignment will result in a reduction of the Company's workforce by approximately 12%. Currently, the Company expects to incur approximately \$600,000 in costs associated with the restructuring, however, the ultimate costs associated with the restructuring have not yet been determined, and will vary depending on the locations, facilities, and individuals involved.

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read together with the unaudited condensed consolidated financial statements and related notes appearing in Item 1 of this report on Form 10-Q and the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements and related notes included in SupportSoft's Annual Report on Form 10-K for the year ended December 31, 2004.

This report on Form 10-Q contains forward-looking statements. These statements relate to our, and in some cases our customers', future plans, objectives, expectations, intentions and financial performance, as well as statements as to our intent to invest in product development and technologies, create more "out-of-the box" solutions, establish a continuous feedback loop for product enhancements and supplement our international expansion with channel partners, the expected operating reduction from our recent realignment, the belief that our additional internal controls will be effective in remediating our material weakness, the possibility of acquisitions, the anticipated percentage of total revenue that ratable licensing arrangements, perpetual licensing arrangements and professional services may constitute in future periods, the expectation that license revenue from ratable arrangements and revenue from services will vary from period to period as a percentage of total revenue, expected cash flows, the adequacy of capital resources, the expectation that internally developed applications will continue to be a principal source of competition, the ability to compete and respond to technological change and the acceptance and performance of our products and services and our belief as to the merits or potential outcome of any litigation. In some cases, you can

identify forward-looking statements because we use terms such as anticipates, believes, continue, could, enable, estimates, expects, intends, may, plans, potential, predicts, should or will or the negative of those terms or other comparable words. These statements involve risks and uncertainties that may cause our actual results, activities or achievements to be materially different from those expressed or implied by these statements. These risks and uncertainties include those listed under Factors that May Affect Future Results and Management's Discussion and Analysis of Financial Condition and Results of Operations.

SupportSoft expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained in this report to conform these statements to actual results or changes in our expectations or in events, conditions or circumstances on which any such statement is based. You should not place undue reliance on these forward-looking statements, which apply only as of the date hereof.

Overview

We develop, market and distribute real-time service management software designed to solve technical problems associated with delivering and servicing technology-based services or products. Our software solutions are utilized by:

- Broadband service providers, to provide automated installation, verification and support of the broadband data, voice over Internet protocol (VoIP), and digital video services they provide to their subscribers;
- Corporate enterprises, either directly or as part of an outsourced solution from managed service providers, to provide IT service and support automation to customers, partners and employees; and
- Software vendors and application providers, to solve technical problems related to the software they provide to their customers.

We license our software predominately on a perpetual basis. We recognize revenue from perpetual licenses at one point in time, or several points in time in the event payment terms are beyond our normal practice. We refer to this type of revenue as "immediate" revenue. We also license our software under time-based term licenses. We recognize revenue from term licenses ratably over the length of the agreement with the customer. We refer to this type of revenue as "ratable" revenue. In some cases, however, perpetual licenses result in "ratable" revenue. For example, if a customer purchases a technology subscription to unspecified future products, the revenue would be taken ratably over the length of the subscription period. Most of the ratable license revenue recognized in the first nine months of 2005 related to license arrangements from prior periods. Most new license arrangements to date in 2005 have resulted in, and in the future will likely result in, immediate rather than ratable license revenue.

We also derive revenue from consulting and training services and maintenance and support. Maintenance and support fees relating to perpetual software licenses result in ratable revenue over the length of the maintenance and support term. Our consulting and training services are generally recognized over time or based on achievement of milestones as services are performed, but not necessarily evenly each month. We include consulting and training services in our definition of ratable revenue. Among the many factors we use in evaluating our business, we consider the mix of ratable revenue and immediate revenue for visibility into our future revenue.

Our total revenues increased by 6% for the quarter ended September 30, 2005 from the same quarter in 2004 and total revenue for the nine months ended September 30, 2005 increased by 3% over the comparable period in 2004. Our diluted earnings per share was \$0.00 for the quarter ended September 30, 2005 compared to (\$0.01) for the quarter ended September 30, 2004. However, our total revenue decreased by 24% over the quarter ended June 30, 2005 and our diluted earnings per share decreased by \$0.05 from the quarter ended June 30, 2005. Our decrease in total revenues and diluted earnings per share from the prior quarter was due primarily to a 42% decrease in license revenue from the quarter ended June 30, 2005. We did not close a number of expected license transactions we were working on near the end of the third quarter of 2005.

In October 2005, we performed a review of our business operations and realigned our resources and go-to-market strategies to maximize our revenue opportunities. This realignment has resulted in a reduction of our workforce by approximately 12%. As a result of this realignment, we have refocused our efforts on the markets and customer segments where we believe our solutions provide the most tangible business value. In addition to realizing the expected cost savings from our realignment, we intend to create and deliver more "out-of-the-box" automated solutions, create and deliver services offerings focused on specific customer problem areas, more closely align our professional services organization with the products organization to establish a continuous feedback loop for product enhancements, and supplement our direct international expansion with channel partners. We have realigned a number of executive and management positions to help drive these initiatives. We consolidated our product initiatives under one executive, Cadir Lee, who was formerly our Vice President of Engineering. Mr. Lee will now be the Senior Vice President

of Products and Technology and Chief Technology Officer. Our former Chief Technology Officer and founder, Scott Dale, has recently resigned from the Company to pursue personal interests. A Vice President of Engineering for North America as well as a General Manager and Vice President of Engineering and Services for SupportSoft-India have been appointed and will be reporting to Mr. Lee. Chris Grejtak, formerly the Senior Vice President of Products and Marketing and Chief Marketing Officer, is now our Senior Vice President of Marketing & Corporate Development and Chief Marketing Officer. Mr. Grejtak's responsibility will be to focus on corporate strategy, business development and world-wide alliances.

Although we anticipate costs savings from our realignment, we may not be able to ultimately recognize these savings and the realignment may adversely affect our ability to grow our license revenues. Our financial performance may be affected by other factors, such as a slowdown in enterprise IT spending or a decrease in the demand for enterprise software. Competitive pressures, including from new competitors or alliances or mergers among competitors, could reduce our market share or require us to reduce the price of products and services, thereby also impacting our operating results. Furthermore, we typically derive a large portion of our revenue each quarter from a small number of orders received in the last month of a quarter. If we fail to close orders expected to be completed toward the end of a quarter, particularly if these orders are for perpetual licenses or large customer orders, our quarterly results would suffer. In conjunction with this, as further described under results of operations, immediate license revenue is becoming a larger percentage of our total revenue, which results in less ratable license revenue and more dependence on a few customers for a substantial portion of our license revenue in any single quarter.

We intend the discussion of our financial condition and results of operations that follows to provide information that will assist in understanding our financial statements, the changes in certain key items in those financial statements from year to year, and the primary factors that accounted for those changes, as well as how certain accounting principles, policies and estimates affect our financial statements.

Critical Accounting Policies and Estimates

In preparing our consolidated financial statements in conformity with accounting principles generally accepted in the United States, we make assumptions, judgments and estimates that can have a significant impact on our net revenue, operating income and net income, as well as on the value of certain assets and liabilities on our consolidated balance sheet. We base our assumptions, judgments and estimates on historical experience and various other factors that we believe to be reasonable under the circumstances. Actual results could differ materially from these estimates under different assumptions or conditions. On a regular basis we evaluate our assumptions, judgments and estimates and make changes accordingly. We believe that the assumptions, judgments and estimates involved in the accounting for revenue recognition, allowance for doubtful accounts, valuation allowance and realization of deferred tax assets have the greatest potential impact on our consolidated financial statements, so we consider these to be our critical accounting policies. We discuss below the critical accounting estimates associated with these policies. Historically, our assumptions, judgments and estimates relative to our critical accounting policies have not differed materially from actual results. For further information on the critical accounting policies, see Note 1 of our Notes to Consolidated Financial Statements.

Revenue Recognition

We recognize revenue in accordance with current generally accepted accounting principles that have been prescribed for the software industry. Revenue recognition requirements in the software industry are very complex and are subject to change. Our revenue recognition policy is one of our critical accounting policies because revenue is a key component of our results of operations and is based on complex rules which require us to make judgments. In applying our revenue recognition policy we must determine which portions of our revenue are recognized currently and which portions must be deferred. In order to determine current and deferred revenue, we make judgments with regard to future services and the appropriate pricing for those services. We also make judgments as to whether future services are essential to the functionality of other elements of the software arrangement. Our assumptions and judgments regarding future services could differ from actual events.

We do not record revenue on sales transactions when the collection of cash is in doubt at the time of sale. Rather, revenue is recognized from these transactions as cash is collected. The determination of collectibility requires significant judgment.

Allowance for Bad Debt

We maintain reserves for estimated credit losses resulting from the inability of our customers to make required payments. A considerable amount of judgment is required when we assess the realization of receivables, including assessing the probability of collection and the current credit-worthiness of each customer. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional reserves may be required.

Accounting for Income Taxes

As part of the process of preparing consolidated financial statements, we are required to estimate our income taxes in each of the tax jurisdictions in which we operate. This process involves management's estimation of our actual current tax exposure together with an assessment of temporary differences resulting from different treatments between tax and accounting of certain items. These differences result in net deferred tax assets and liabilities, which are included within the consolidated balance sheet. We must then assess the likelihood that the deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or adjust this allowance in a period, we must include a tax expense or benefit within the tax provision in the statement of operations.

Business Combinations

When we acquire businesses, we allocate the purchase price to tangible assets and liabilities acquired and identifiable intangible assets. Any residual purchase price is recorded as goodwill. We engage independent third party appraisal firms to assist in determining the fair values of assets acquired and liabilities assumed. Such a valuation requires management to make significant estimates, especially with respect to intangible assets. These estimates are based on historical experience and information obtained from the management of the acquired companies. These estimates can include, but are not limited to, the cash flows that an asset is expected to generate in the future, the appropriate weighted average cost of capital, and the cost savings expected to be derived from acquiring an asset. These estimates are inherently uncertain and unpredictable. In addition, unanticipated events and circumstances may occur which may affect the accuracy or validity of such estimates.

At September 30, 2005, goodwill was \$9.8 million, and other identifiable intangible assets were \$4.3 million. We assess the impairment of goodwill annually or more often if events or changes in circumstances indicate that the carrying value may not be recoverable. An impairment loss would be recognized when the estimated fair value of the asset is less than the carrying value. If we change our estimates, material differences may result in write-downs of net long-lived and intangible assets, which would be reflected by charges to our operating results for any period presented. Management has concluded its annual evaluation for impairment of goodwill as of August 31, 2005 and no impairment was recognized.

RESULTS OF OPERATIONS

The following table sets forth the results of operations for the three and nine months ended September 30, 2005 and 2004 expressed as a percentage of total revenue.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Revenue:				
License fees	42%	47%	51%	63%
Services	58	53	49	37
Net revenue	100	100	100	100
Costs and expenses:				
Cost of license fees	1	—	1	—
Cost of services	27	20	23	16
Amortization of intangible assets	2	1	2	—
Research and development	21	19	18	16
Sales and marketing	41	45	40	39
General and administrative	16	14	14	10
In-process research and development	—	13	—	4
Total costs and expenses	108	112	98	85
Income (loss) from operations	(8)	(12)	2	15
Interest and other income, net	7	5	5	4
Income (loss) before income taxes	(1)	(7)	7	19
Income tax benefit (expense)	0	4	0	(1)
Net income (loss)	(1)%	3%	7%	18%

Three and Nine Months Ended September 30, 2005

Revenue

We generate revenue primarily from software licenses and related services. We offer our products through a combination of direct sales, managed service providers, and resellers.

License fees. License fees decreased to \$5.4 million for the three months ended September 30, 2005 from \$5.7 million for the three months ended September 30, 2004 and to \$23.8 million for the nine months ended September 30, 2005 from \$28.4 million for the nine months ended September 30, 2004. Included in license revenues for the nine months ended September 30, 2005 is \$2.5 million related to the payment of an obligation originally due next year from a customer that had disclosed that it may not have sufficient funding to meet its cash requirements in 2006. The Company negotiated an accelerated payment with the customer to eliminate any potential credit risk. The year-over-year decreases in license revenues reflected fewer large new licensing transactions in 2005. In addition, the decrease in license revenues was due in part to a large ratable license arrangement that was fully recognized by August 2004, and therefore was not included in the comparable periods in 2005. License revenues from this arrangement included in the three and nine month periods ended September 30, 2004 were \$1.0 million and \$4.0 million, respectively. Almost all of our recent customer contracts have been for perpetual licenses which generally result in immediate license revenues therefore the percentage of total revenues from ratable license revenues has been decreasing. For the three and nine month periods ended September 30, 2005, ratable license revenues represented approximately 6% of total revenues. For the three and nine month periods ended September 30, 2004, ratable license revenues represented 17% and 20% of total revenues, respectively. Most of the ratable license revenue recognized in the first nine months of 2005 related to license arrangements from prior periods. Most new license arrangements so far in 2005 have resulted in, and in the future will most likely result in immediate rather than ratable license revenue. As a result, the failure to enter into significant perpetual licenses in any particular quarter could cause our license revenues to fluctuate on a quarterly basis.

Services revenue. Services revenue increased to \$7.6 million for the three months ended September 30, 2005 from \$6.5 million for the three months ended September 30, 2004 and to \$22.4 million for the nine months ended September 30, 2005 from \$16.4 million for the nine months ended September 30, 2004. Services revenue increased year-over-year due to additional implementation services provided to new and existing customers and increased maintenance revenue associated with more perpetual licensing arrangements.

Revenue from customers outside the United States accounted for approximately 21% and 23% of our total revenues for the three and nine month periods ended September 30, 2005, compared with 12% and 11% for the three and nine month periods ended September 30, 2004. Most of our international revenues have come from customers in Europe.

We anticipate that revenue we recognize on an immediate basis from perpetual licensing arrangements will be approximately 50% to 55% of total revenue. Although the percentage of revenue we recognize in the future from services will vary from period to period, we currently anticipate that revenue from services will represent approximately 45% to 50% of total revenue. Similarly, although the percentage of revenue we recognize in the future from ratable licensing arrangements will vary from period to period, we currently anticipate that revenue from such arrangements over the next twelve months will represent less than 5% of our total revenue.

Cost of license fees

Cost of license fees consists primarily of costs related to third-party royalty fees under license arrangements for technology embedded into our products. Cost of license fees increased to \$123,000 in the three months ended September 30, 2005 from \$46,000 in the three months ended September 30, 2004. Cost of license fees increased to \$440,000 for the nine months ended September 30, 2005 from \$209,000 for the same period in 2004. These year-over-year increases were due primarily to royalties for third party technology or products integrated or resold with our products.

Cost of services

Cost of services consists primarily of compensation costs, travel costs, related overhead expenses for professional services personnel and payments made to third parties for subcontracted consulting services. Cost of services increased to \$3.5 million for the three months ended September 30, 2005 from \$2.5 million for the three months ended September 30, 2004. Cost of services for the nine months ended September 30, 2005 increased to \$10.6 million from \$7.1 million for the same period in 2004. These year-over-year increases were due primarily to increases in salary and related expenses and travel expenses as a result of increases in professional services personnel as well as increases in the use of third party consultants to address customer demand for our professional services.

Amortization of intangible assets

Amortization of intangible assets was \$272,000 for the three months ended September 30, 2005 and \$92,000 for the three months ended September 30, 2004. Amortization of intangible assets was \$816,000 for the nine months ended September 30, 2005 and \$92,000 for the same period in 2004. The increase in amortization of intangible assets is due to the acquisition of substantially all of the assets of Core Networks which was effective as of September 2, 2004.

Operating Expenses

Research and development. Research and development costs are expensed as incurred. Research and development expense consists primarily of compensation costs, consulting expenses and related overhead costs for research and development personnel. Research and development expense increased to \$2.7 million for the three months ended September 30, 2005 from \$2.3 million for the three months ended September 30, 2004. Research and development expense increased to \$8.5 million for the nine months ended September 30, 2005 from \$7.0 million for same period in 2004. Year-over-year increases were due to increases in salary and related expenses, primarily due to the addition of former Core Networks employees and related overhead costs, partially offset by lower third-party consulting costs.

Sales and marketing. Sales and marketing expense consists primarily of compensation costs, including salaries, sales commissions and related overhead costs for sales and marketing personnel and promotional expenses, including public relations, advertising and trade shows. Sales and marketing expense decreased to \$5.3 million for the three months ended September 30, 2005 from \$5.4 million for the three months ended September 30, 2004. Sales and marketing expense increased to \$18.4 million for the nine months ended September 30, 2005 from \$17.5 million for the same period in 2004. The decrease for the three months ended September 30, 2005 compared to the same period last year was due to decreases in marketing activities and third party consulting partially offset by increases in travel and salaries and related expenses. The increase for the nine months ended September 30, 2005 compared with the same period last year was due to increases in salary and related expenses, international marketing events, and travel expenses partially offset by decreases in consulting expenses.

General and administrative. General and administrative expense consists primarily of compensation costs and related overhead costs for administrative personnel and professional fees for legal, accounting and other professional services. General and administrative expense increased to \$2.1 million for the three months ended September 30, 2005 from \$1.7 million for the three months ended September 30, 2004. General and administrative expense increased to \$6.4 million for the nine months ended September 30, 2005 from \$4.5 million for the same period in 2004. These year-over-year increases were due primarily to increases in salaries, fees for professional services related to Sarbanes-Oxley compliance and legal fees related to a class action lawsuit.

In-process research and development. In-process research and development decreased to zero for the three months ended September 30, 2005 from \$1.6 million for the three months ended September 30, 2004. The in-process research and development expense was a one-time expense related to the acquisition of substantially all of the assets of Core Networks on September 2, 2004.

Interest income and other, net. Interest income and other, net increased to \$909,000 for the three months ended September 30, 2005 from \$599,000 for the three months ended September 30, 2004. Interest income and other net, increased to \$2.5 million for the nine months ended September 30, 2005 from \$1.8 million for the same period in 2004. These year-over-year increases were due primarily to an increase in interest income in 2005 partially offset by a decrease in other income as a result of a settlement payment received from a customer in 2004.

Income tax benefit / expense. The income tax benefit of \$77,000 for the three months ended September 30, 2005 compared with \$481,000 for the three months ended September 30, 2004. The income tax expense decreased to \$176,000 for the nine months ended September 30, 2005 from \$608,000 for the same period in 2004. The income tax benefit for the three months ended September 30, 2005 reflects a tax benefit on the loss in the quarter at the projected effective tax rate for the year and a benefit from true-ups related to tax returns that were filed in the quarter ended September 30, 2005. The income tax expense recorded for the nine month periods ended September 30, 2005 reflects a decrease from the same period in 2004 due to lower pre-tax income in 2005 as compared to 2004 and the projected utilization of previously unbenefited net operating losses in 2005 that were not available for utilization in 2004 due to limitations under Section 382 of the Internal Revenue Code. The effective tax rate used to record the provision for income taxes in the three and nine months ended September 30, 2005 and the three and nine months ended September 30, 2004 differed from the expected US federal statutory rate primarily due to the utilization of previously unbenefited net operating losses.

Each quarter, we evaluate the realizability of our deferred tax assets. At September 30, 2005, we recorded a full valuation allowance against our deferred tax assets based on the realization criteria outlined in the applicable accounting literature. Amongst other important factors, we have considered and will continue to consider its history of earnings and its ability to generate pre-tax income in the future. Giving appropriate consideration to all the relevant factors and assuming we perform as we expect in the future, we believe the release of a portion of our valuation allowance will be appropriate at some point in the future. This would result in an income tax benefit within the statement of operations in the period of adjustment.

LIQUIDITY AND CAPITAL RESOURCES

Since our incorporation in December 1997, we have financed our operations primarily through our initial public offering, follow-on public offering, cash flows from operations and, to a lesser extent, from the private placement of our preferred and common stock, bank borrowings and capital equipment lease financing. In November 2003, we completed our follow-on public offering from which we received net proceeds of approximately \$77.7 million.

Operating Activities

Net cash provided by/(used in) operating activities was \$(3.5) million and \$10.3 million for the nine months ended September 30, 2005 and 2004, respectively. Net cash used in operating activities for the nine months ended September 30, 2005 was primarily the result of net income of \$3.3 million more than offset by an increase in accounts receivable, net, of \$3.3 million and a decrease in deferred revenue of \$5.2 million. Net cash generated by operating activities for the nine months ended September 30, 2004 was primarily the result of net income of \$8.1 million and a decrease in accounts receivable, net, of \$4.1 million, offset by a decrease in deferred revenue of \$6.7 million.

Investing Activities

Net cash provided by/(used in) investing activities was \$5.1 million and \$(23.0) million for the nine months ended September 30, 2005 and 2004, respectively. Net cash provided by investing activities for the nine months ended September 30, 2005, was due primarily to the sale and maturity of \$77.7 million of short term investments, offset by purchases of \$71.8 million in short-term investments and capital expenditures of \$1.0 million. Net cash used in investing activities for the nine months ended September 30, 2004, was due primarily to purchases of short term investments of \$113.6 million and net cash outlay of \$17.6 million to acquire substantially all of the assets of Core Networks and capital expenditures of \$743,000, partially offset by sales and maturities of short term investments of \$108.9 million.

Financing Activities

Net cash generated by financing activities was \$1.1 and \$3.9 million for the nine months ended September 30, 2005 and 2004, respectively, and results primarily from the purchase of common stock under the employee stock purchase plan and the exercise of employee stock options. On April 27, 2005, the Company's board of directors authorized the repurchase of up to 2,000,000 outstanding shares of the Company's common stock. In the second quarter of 2005, the Company repurchased 192,598 shares of outstanding common stock at a cost of \$922,294 or an average cost of \$4.76 per share, excluding commissions. As of September 30, 2005, the maximum number of shares remaining that can be repurchased under this program was 1,807,402.

Working Capital and Capital Expenditure Requirements

At September 30, 2005, we had stockholders' equity of \$132.1 million and working capital of \$115.7 million. Included as a reduction to working capital is deferred revenue of \$11.5 million, which will not require dollar for dollar of cash to settle, but will be recognized as revenue in the future. We believe that our existing cash balances will be sufficient to meet our working capital and stock repurchase requirements, as well as our planned capital expenditures for at least the next 12 months.

If we require additional capital resources to grow our business internally or to acquire complementary technologies and businesses at any time in the future, we may seek to sell additional equity or debt securities. The sale of additional equity or debt securities could result in more dilution to our stockholders. Financing arrangements may not be available to us, or may not be available in amounts or on terms acceptable to us.

Other Factors Affecting our Business and Operating Results

Our quarterly results are difficult to predict and may fluctuate, which may cause our stock price to decline.

Our quarterly revenue and operating results are difficult to predict and may fluctuate from quarter to quarter. As a result, we believe that quarter-to-quarter and year-to-year comparisons of our revenue and operating results are not necessarily meaningful, and that these comparisons may not be accurate indicators of future performance. Our operating results in future quarters may fall below our guidance or the expectations of securities analysts or investors, which would likely cause the market price of our common stock to decline.

Several factors that have contributed or may in the future contribute to fluctuations in our operating results include:

- demand for our support and service automation software;
- size and timing of customer orders and our ability to receive payment and recognize revenue in a given quarter;
- the mix of license revenue from perpetual arrangements with immediate recognition versus license revenue from ratable arrangements;
- the price and mix of products and services we or our competitors offer;
- our ability to attract and retain customers;
- the amount and timing of operating costs and capital expenditures relating to expansion of our business, infrastructure and marketing activities;
- the exercise of judgment by our management in making accounting decisions in accordance with our accounting policies, such as when to recognize certain tax assets and the impairment of goodwill;
- general economic conditions and their effect on our operations; and
- the effects of external events such as terrorist acts and any related conflicts or similar events worldwide.

We license our software under perpetual and term licenses. Under perpetual licenses, we generally recognize all of the revenue from a customer at one point in time, which is immediately upon delivery of our product under the terms of the agreement. Under term licenses, we generally recognize revenue ratably over the length of the agreement with the customer. Perpetual licenses with an "immediate" recognition of revenue represent most of our business and as a result, we will experience less predictability in future results due to our recognition of all or significant portions of the license fees as revenue at the time we enter into these perpetual license arrangements. In addition, we typically derive a significant portion of our total revenue each quarter from a number of orders received in the last month of a quarter. If we fail to close orders expected to be completed toward the end of a quarter, particularly if these orders are for perpetual licenses with immediate revenue, or if there is any cancellation of or delay in the closing of orders, particularly any large customer orders, our quarterly results would suffer.

Because a small number of customers have historically accounted for and may in future periods account for substantial portions of our revenue, our revenue could decline because of delays of customer orders.

A small number of customers have historically accounted for, and may in future periods account for, substantial portions of our revenue. For the three months ended September 30, 2005, one customer accounted for 19% of our total revenue. For the nine months ended September 30, 2005, the same customer along with another each accounted for 11% of our total revenues. Because a small number of customers are likely to continue to account for a significant portion of our revenue in any given quarter, our revenue could decline because of the loss or delay of a single customer order. We may not obtain new customers. The failure to obtain new customers, particularly customers that purchase perpetual licenses, the loss or delay of customer orders and the failure of existing customers to renew licenses or pay ongoing fees when due would harm our operating results.

We were not profitable for the third quarter of 2005 and may not achieve profitability again.

Although we have been profitable on an annual basis since 2003, we were not profitable for the third quarter of 2005. Our expenditures could continue to exceed our revenues, thus preventing us from once again achieving and maintaining profitability. To achieve and maintain profitability, we will need to generate and sustain substantially higher revenues while maintaining reasonable cost and expense levels. If we fail to achieve profitability, the market price of our common stock will likely decline. We may not achieve profitability if our revenues do not increase or if they increase more slowly than we expect. In addition, our operating expenses are largely fixed and any shortfall in anticipated revenues in any given period could harm our results.

Our sales cycle can be lengthy and if revenue forecasted for a particular quarter is not realized in that quarter, significant expenses incurred may not be offset by corresponding revenues.

Our sales cycle for our software typically ranges from three to nine months or more and may vary substantially from customer to customer. The purchase of our products and services generally involves a significant commitment of capital and other resources by a customer. This commitment often requires significant technical review, assessment of competitive products and approval at a number of management levels within a customer's organization. In addition, in the wake of Sarbanes-Oxley, sales cycles appear to be lengthening as companies enhance their approval processes. While our customers are evaluating our products and services, we may incur substantial sales and marketing expenses and spend significant management effort to complete these sales. Any delay in completing sales in a particular quarter could cause our operating results to suffer.

We must achieve broad adoption and acceptance of our real-time service management products and services or we will not increase our market share or expand our business.

We must achieve broad market acceptance and adoption of our products and services or our business and operating results will suffer. Specifically, we must encourage our customers to transition from using traditional support and service methods to our support and service automation solutions. To accomplish this, we must:

- continually improve the performance, features and reliability of our products and services to address changing industry standards and customer needs; and
- develop integration with other support-related technologies.

If we fail to manage our business effectively, then our infrastructure, management and resources might be strained.

If we experience rapid growth in the future, it will likely place a significant strain on our resources especially in light of the recent reduction in the Company's workforce. With less personnel, or in the event we are unable to retain the required personnel, we may be unable to meet our business objectives. In addition, if we experience significant and rapid growth, including through acquisitions of businesses or technologies, we may need to expand and otherwise improve our internal systems, including our internal control over financial reporting, disclosure controls and procedures, management information systems, customer relationship and support systems, and other operating and administrative systems and controls. This effort may cause us to make significant capital expenditures or incur significant expenses, and divert the attention of management, sales, support and finance personnel from our business operations, which may adversely affect our financial performance in one or more quarters. Moreover, growth in the future will result in increased responsibilities of management personnel. Managing growth will require substantial resources that we may not have or otherwise be able to obtain.

If we are unable to successfully address the material weaknesses in our disclosure controls and procedures, including our internal control over financial reporting, our ability to report our financial results on a timely and accurate basis may be adversely affected.

We have evaluated our “disclosure controls and procedures” as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as well as our internal control over financial reporting as required by Section 404 of the Sarbanes-Oxley Act of 2002. Our independent registered public accounting firm has performed a similar evaluation of our internal control over financial reporting. Effective controls are necessary for us to provide reliable financial reports and effectively prevent fraud. If we cannot provide reliable financial reports or prevent fraud, our operating results could be harmed. As of December 31, 2004, we concluded that we had deficiencies in our internal control over financial reporting that constituted two material weaknesses, as further described below in Item 4, Controls and Procedures. We have implemented corrective actions, which we believe have remediated or will remediate these deficiencies. However, we cannot be certain that these measures will result in adequate controls over our financial processes and reporting in the future. If these actions are not successful in addressing these material weaknesses or if other weaknesses are identified, our ability to report our financial results on a timely and accurate basis may be adversely affected. In addition, if we cannot establish effective internal control over financial reporting and disclosure controls and procedures, investors may lose confidence in our reported financial information, which could have a negative effect on the trading price of our common stock.

We are becoming increasingly more dependent upon our international operations and if our revenue from this effort does not exceed the expense of establishing and maintaining international operations, our business could suffer.

We are becoming increasingly more dependent upon our international operations including the sales and distribution of our products and services and our research and development resources in India. We have limited experience in international operations and may not be able to compete effectively in international markets or effectively manage our operations in various countries. If we do not generate enough revenue from international operations to offset the expense of these operations, our business and our ability to increase revenue and enhance our operating results could suffer. Risks we face in conducting business internationally include:

- costs of staffing and managing international operations;
- differing technology standards and legal considerations;
- longer sales cycles and collection periods;
- dependence on local vendors;
- difficulties in staffing and managing international operations, including the difficulty in managing a geographically dispersed workforce in compliance with diverse local laws and custom and difficulty in motivating and retaining qualified individuals;
- potential adverse tax consequences;
- changes in currency exchange rates and controls;
- restrictions on repatriation of earnings from our international operations;
- difficulties in maintaining effective internal control over financial reporting as a result of a geographically-dispersed workforce and customers;
- longer collection cycles for accounts receivable; and
- the effects of external events such as terrorist acts and any related conflicts or similar events worldwide.

If our existing customers do not renew maintenance services or term licenses or purchase additional products, our operating results could suffer.

Historically, we have derived, and expect to continue to derive, a significant portion of our total revenue from existing customers who purchase additional products or renew term licenses and maintenance services. Our customers may not renew maintenance services or term licenses or purchase additional products and may not expand their use of our products. In addition, as we introduce new products, our current customers may not require or desire the functionality of our new products and may not ultimately purchase these products. If our customers do not renew maintenance services or term licenses or do not purchase additional products, our revenue levels and operating results could suffer.

Our product innovations may not achieve the market penetration necessary for us to expand our market share.

If we fail to develop new or enhanced versions of our real-time service management software in a timely manner or to provide new products and services that achieve rapid and broad market acceptance, we may not maintain or expand our market share. We may fail to identify new product and service opportunities for our current market or new markets that we enter into in the future. In addition, our existing products will become obsolete if we fail to introduce new products or product enhancements that meet new customer demands, support new standards or integrate with new or upgraded versions of packaged applications. We have limited control over factors that affect market acceptance of our product and services, including:

- the willingness of enterprises, including management service providers, to transition to support and service automation solutions; and
- acceptance of competitors' solutions or other similar technologies.

Our software may not operate with the hardware and software platforms that are used by our customers now or in the future, and as a result our business and operating results may suffer.

We currently serve a customer base with a wide variety of constantly changing hardware, packaged software applications and networking platforms. If we fail to release versions of our software that are compatible with operating systems, software applications or hardware devices used by our customers, our business and operating results would suffer. Our future success also depends on:

- the ability of our products to inter-operate with multiple platforms and to modify our products as new versions of packaged applications are introduced and used by our customer base; and
- our management of software being developed by third parties for our customers or for use with our products.

We may engage in investments or acquisitions or other strategic matters that could divert management attention and prove difficult to integrate with our business and technology.

We may engage in acquisitions of other companies, products or technologies or in other strategic initiatives. If we fail to integrate successfully any future acquisitions, or the technologies associated with such acquisitions, into our company, or if we fail to consummate various strategic initiatives, the revenue and operating results of the combined company could decline. The process of integrating businesses, technologies, services or products may result in unforeseen operating difficulties and expenditures. Acquisitions involve a number of other potential risks to our business, including the following:

- potential adverse effects on our operating results, including unanticipated costs and liabilities, unforeseen accounting charges or fluctuations resulting from failure to accurately forecast the financial impact of an acquisition;
- failure to integrate products or technologies with our existing products, technologies and business model;
- failure to integrate management information systems, personnel, research and development and marketing, sales and support operations;
- potential loss of key employees;
- diversion of management's attention from other business concerns and disruption of our ongoing business;
- difficulty in maintaining controls and procedures;

- potential loss of customers;
- uncertainty on the part of our existing customers about our ability to operate on a combined basis;
- failure to realize the potential financial or strategic benefits of the acquisition; and
- failure to successfully further develop the combined technology, resulting in the impairment of amounts capitalized as intangible assets.

In addition, our capital resources may be insufficient to acquire businesses, technology, services or products and we may require additional financing. This financing may not be available in sufficient amounts or on terms acceptable to us and may be dilutive to existing stockholders.

We rely on third-party technologies and our inability to use or integrate third-party technologies could delay product or service development.

We intend to continue to license technologies from third parties, including applications used in our research and development activities and technologies such as third-party search engine technology, which are integrated into our products and services. Our inability to obtain or integrate any of these technologies with our own products could delay product and service development until equivalent technology can be identified, licensed and integrated. These technologies may not continue to be available to us on commercially reasonable terms or at all. We may fail to successfully integrate any licensed technology into our products or services, which would harm our business and operating results. Third-party licenses also expose us to increased risks that include:

- risks of product malfunction after new technology is integrated;
- the diversion of resources from the development of our own proprietary technology; and
- our inability to generate revenue from new technology sufficient to offset associated acquisition and maintenance costs.

Our failure to establish and expand third-party alliances would harm our ability to sell our real-time service management software.

We have several alliances with third parties that are important to our business. Our existing relationships include those with software and hardware vendors, and relationships with companies who provide outsourced support and service capabilities to enterprise customers. If these relationships fail, we may have to devote substantially more resources to the sales and marketing of our products and services than we would otherwise, and our efforts may not be as effective. For example, companies that provide outsourced support and services often have extensive relationships with our existing and potential customers and significant input in the purchase decisions of these customers. Our failure to maintain these existing relationships, or to establish new relationships with key third parties, could significantly harm our ability to sell our products and services.

We may lose the services of our key personnel, which in turn would harm the market's perception of our business and our ability to achieve our business goals.

Our success will depend on the skills, experience and performance of our senior management, engineering, sales, marketing and other key personnel. The loss of the services of any of our senior management or other key personnel, including Radha R. Basu, our president, chief executive officer and chairman, Brian Beattie, our executive vice president of finance and administration and chief financial officer, Cadir B. Lee, our senior vice president of products and technology and chief technology officer, Chris Grejtak, our senior vice president of marketing and corporate development and chief marketing officer, and John Van Siclen, our senior vice president of worldwide field operations, could harm the market's perception of our business and our ability to achieve our business goals. In addition, if the integration of new members of our senior management team does not go as smoothly as anticipated, it could negatively affect our ability to execute our business plans. We have also recently initiated reductions in our workforce. Reductions in our workforce could make it difficult to motivate and retain remaining key employees or attract new employees, and provide distractions affecting our ability to manage our business.

We must compete successfully in the real-time service management market or we will lose market share and our business will suffer.

We compete in markets that are highly competitive, subject to rapid change and significantly affected by new product introductions and other market activities of industry participants. We compete with a number of companies in the market for automated delivery of support and service endpoint management and other vendors who may offer products or services with features that compete with specific elements of our software suites or with our component products. In addition, our customers and potential customers have developed or may develop internally real-time service management software systems. We expect that internally developed applications will continue to be a principal source of competition in the foreseeable future.

The markets for our products are still rapidly evolving, and we may not be able to compete successfully against current and potential competitors. Our ability to expand our business will depend on our ability to maintain our technological advantage, introduce timely enhanced products to meet the growing support needs, deliver on-going value to our customers and scale our business. Our potential competitors may have longer operating histories, significantly greater financial, technical and other resources or greater name recognition than we do. Competition in our markets could reduce our market share or require us to reduce the price of products and services, which could harm our business, financial condition and operating results.

We may need additional capital and if funds are not available on acceptable terms, we may not be able to hire and retain employees, fund our expansion or compete effectively.

We believe that our existing capital resources will enable us to maintain our operations for at least the next 12 months. However, if our capital requirements vary materially from those currently planned, we may require additional financing sooner than anticipated. This financing may not be available in sufficient amounts or on terms acceptable to us and may be dilutive to existing stockholders. If adequate funds are not available or are not available on acceptable terms, our ability to hire, train or retain employees, fund our expansion, take advantage of business opportunities, develop or enhance services or products or respond to competitive pressures would be significantly limited.

Our system security is important to our customers and we may need to spend significant resources to protect against or correct problems caused by security breaches.

A fundamental requirement for online communications, transactions and support is the secure transmission of confidential information. Third parties may attempt to breach our security or that of our customers. We may be liable to our customers for any breach in security and any breach could harm our business and reputation. Also, computers are vulnerable to computer viruses, physical or electronic break-ins and similar disruptions, which could lead to interruptions, delays or loss of data. We may be required to expend significant capital and other resources to further protect against security breaches or to correct problems caused by any breach.

Failure to resolve pending securities claims and other lawsuits may lead to continued costs and expenses and divert management's attention from our business, which could cause our revenues and our stock price to decline.

In the past, securities class action litigation has often been brought against public companies after periods of volatility in the market price of securities. The market price of our common stock has been subject to significant fluctuations and may continue to fluctuate or decline. In addition, the anti-takeover provisions we have adopted in the past, such as prohibiting stockholder action by written consent, or may adopt in the future may be perceived negatively by the market causing a decline in our stock price or litigation against us. Securities class action lawsuits were filed against us in November 2001 and again in December 2004. Should these lawsuits linger for a long period of time, whether ultimately resolved in our favor or not, or further lawsuits be filed against us, coverage limits of our insurance or our ability to pay such amounts may not be adequate to cover the fees and expenses and any ultimate resolution associated with such litigation. The size of these payments, if any, individually or in the aggregate, could seriously impair our cash reserves and financial condition. The continued defense of these lawsuits also could result in continued diversion of our management's time and attention away from business operations, which could cause our financial results to decline. A failure to resolve definitively current or future material litigation in which we are involved or in which we may become involved in the future, regardless of the merits of the respective cases, could also cast doubt as to our prospects in the eyes of customers, potential customers and investors, which could cause our revenues and stock price to decline.

We may face claims of invasion of privacy or inappropriate disclosure, use or loss of our customers' information and any liability imposed could harm our reputation and cause us to lose customers.

Our software contains features which may allow us or our customers to control, monitor or collect information from computers running the software without notice to the computing users. Therefore we may face claims about invasion of privacy or inappropriate disclosure, use or loss of this information. Any imposition of liability could harm our reputation, cause us to lose customers and cause our operating results to suffer.

Any system failure that causes an interruption in our customers' ability to use our products or services or a decrease in their performance could harm our relationships with our customers and result in reduced revenue.

Our software depends in part on the uninterrupted operation of our internal and outsourced communications and computer systems. These systems are vulnerable to damage or interruption from computer viruses, human error, natural disasters, electricity grid failures and intentional acts of vandalism and similar events. Our disaster recovery plan may not be adequate and insurance may not be enough to compensate us for losses that occur. These problems could interrupt our customers' ability to use our real-time service management products or services, which could harm our reputation and cause us to lose customers and revenue.

We may not obtain sufficient patent protection, which could harm our competitive position, increase our expenses and harm our business.

Our success and ability to compete depend to a significant degree upon the protection of our software and other proprietary technology. It is possible that:

- our pending patent applications may not be issued;
- competitors may independently develop similar technologies or design around any of our patents;
- patents issued to us may not be broad enough to protect our proprietary rights; and
- our issued patents could be successfully challenged.

Our products depend on and work with products containing complex software and if our products fail to perform properly due to errors in the software, we may need to devote resources to correct the errors or compensate for losses from these errors and our reputation could be harmed.

Our products depend on complex software, both internally developed and licensed from third parties. Also, our customers may use our products with other companies' products which also contain complex software. Complex software often contains errors and may not perform properly. These errors could result in:

- delays in product shipments;
- unexpected expenses and diversion of resources to identify the source of errors or to correct errors;
- damage to our reputation;
- lost sales;
- demands, claims and litigation and related defense costs; and
- warranty claims.

If our products fail to perform properly due to errors, bugs or similar problems in the software, we could be required to devote valuable resources to correct the errors or compensate for losses from these errors. Furthermore, if our products are found to contain errors or bugs, whether resulting from internally developed or third-party licensed software, our reputation with our customer base could be harmed and our business could suffer.

We rely upon patents, trademarks, copyrights and trade secrets to protect our proprietary rights and if these rights are not sufficiently protected, it could harm our ability to compete and to generate revenue.

We rely on a combination of laws, such as patents, copyright, trademark and trade secret laws, and contractual restrictions, such as confidentiality agreements and licenses, to establish and protect our proprietary rights. Our ability to compete and grow our business could suffer if these rights are not adequately protected. Our proprietary rights may not be adequately protected because:

- laws and contractual restrictions may not adequately prevent misappropriation of our technologies or deter others from developing similar technologies; and
- policing unauthorized use of our products and trademarks is difficult, expensive and time-consuming, and we may be unable to determine the existence or extent of this unauthorized use.

Also, the laws of other countries in which we market our products may offer little or no protection of our proprietary technologies. Reverse engineering, unauthorized copying or other misappropriation of our proprietary technologies could enable third parties to benefit from our technologies without paying us for them, which would harm our competitive position and market share.

We may face intellectual property infringement claims that could be costly to defend and result in our loss of significant rights.

Other parties may assert intellectual property infringement claims against us or our customers and our products may infringe the intellectual property rights of third parties. Intellectual property litigation is expensive and time-consuming and could divert management's attention from our business. If there is a successful claim of infringement, we may be required to develop non-infringing technology or enter into royalty or license agreements which may not be available on acceptable terms, if at all. Our failure to develop non-infringing technologies or license the proprietary rights on a timely basis would harm our business.

Risks Related To Our Industry

We may experience a decrease in market demand due to uncertain economic conditions in the United States and in international markets, which has been further exacerbated by the concerns of terrorism, war and social and political instability.

The United States and international economies have recently experienced a period of slow economic growth. A sustained economic recovery is uncertain. In addition, the terrorists attacks in the United States and turmoil in the Middle East have increased the uncertainty in the United States economy and may further exacerbate the decline in economic conditions, both domestically and internationally. Terrorist acts and similar events, or war in general, could contribute further to a slowdown of the market demand for goods and services, including real-time service management solutions. If the economy declines as a result of economic, political and social turmoil, or if there are further terrorist attacks in the United States or elsewhere, we may experience decreases in the demand for our products and services, which may harm our operating results.

Governmental regulation and legal changes could impair the growth of the Internet and decrease demand for our products or increase our cost of doing business.

The laws and regulations that govern our business and the business of our customers can change rapidly. Any change in laws and regulations could impair the growth of the Internet and could reduce demand for our products, subject us to liability or increase our cost of doing business. The United States government and the governments of states and foreign countries have attempted to regulate activities on the Internet and the distribution of software. Also, in 1998, the Internet Freedom Act was enacted into law, which imposed a three-year moratorium on state and local taxes on Internet-based transactions. Congress has extended this moratorium on several occasions, including the most recently approved extension to the moratorium until November 1, 2007. Failure to renew this moratorium once again or to pass a bill that would permanently prohibit state and local taxes on Internet-based transactions would allow states to impose taxes on Internet-based commerce. This might harm our business directly and indirectly by harming the businesses of our customers, potential customers and the parties to our technology relationships. The applicability to the Internet of existing laws is uncertain and may take years to resolve. Evolving areas of law that are relevant to our business include privacy laws, intellectual property laws, proposed encryption laws, content regulation and sales and use tax laws and regulations.

We may be required to change our business practices if there are changes in accounting regulations and related interpretations and policies, such as the recent changes in accounting rules for employee stock options.

Accounting standards groups and regulators are actively re-examining various accounting policies, guidelines and interpretations related to revenue recognition, expensing stock options, income taxes, investments in equity securities, facilities consolidation, accounting for acquisitions, allowance for doubtful accounts and other financial reporting matters. These standards groups and regulators could promulgate interpretations and guidance that could result in material and potentially adverse changes to our business practices and accounting policies.

Accounting rules relating to employee stock option grants have recently been revised. The Financial Accounting Standards Board and other agencies have finalized changes to U.S. generally accepted accounting principles that will require us, starting in our first quarter of 2006, to record a charge to earnings for employee stock option grants and other equity incentives. We may have significant and ongoing accounting charges resulting from option grant and other equity incentive expensing that will reduce our overall net income. In addition, since we historically have used equity-related compensation as a component of our total employee compensation program, the accounting change could make the use of equity-related compensation less attractive to us and therefore make it more difficult to attract and retain employees.

New rules and regulations for public companies may increase our administrative costs.

The Sarbanes-Oxley Act of 2002, as well as new rules subsequently implemented by the Securities and Exchange Commission and the Nasdaq National Market, have required changes in corporate governance practices of public companies.

These new rules and regulations are increasing our legal and financial compliance costs, and making some activities more time-consuming and costly. We also expect these new rules and regulations to make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These new rules and regulations could also make it more difficult for us to attract and retain qualified members of our board of directors, particularly to serve on our audit committee, and qualified executive officers.

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

We develop products in the United States and market and sell in North America, South America, Asia and Europe. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. As most sales are currently made in U.S. dollars, a strengthening of the dollar could make our products less competitive in foreign markets.

As of September 30, 2005, we held \$19.2 million in cash and cash equivalents consisting of highly liquid investments having original maturity dates of no more than 90 days. Declines of interest rates over time would reduce our interest income from our highly liquid short-term investments. Based upon our balance of cash and cash equivalents, a decrease in interest rates of 100 basis points would cause a corresponding decrease in our annual interest income of approximately \$192,000. Due to the nature of our highly liquid cash equivalents, a change in interest rates would not materially change the fair market value of our cash and cash equivalents.

As of September 30, 2005, we held \$97.5 million in short-term investments, which consisted primarily of money market funds held by large institutions in the U.S., municipal bonds and commercial paper, and our short-term investments were primarily invested in corporate bonds, government debt securities maturing in less than eighteen months and auction backed securities resetting in less than forty-five days. The weighted average interest rate of our portfolio was approximately 3.68% at September 30, 2005. A decline in interest rates over time would reduce our interest income from our short-term investments. A decrease in interest rates of 100 basis points would cause a corresponding decrease in our annual interest income of approximately \$975,000. Due to the nature of our highly liquid cash equivalents, a change in interest rates would not materially change the fair market value of our short-term investments.

ITEM 4: CONTROLS AND PROCEDURES.

Evaluation of disclosure controls and procedures.

We maintain “disclosure controls and procedures,” as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and 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. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure

controls and procedures are met. Our disclosure controls and procedures have been designed to meet, and management believes they meet, reasonable assurance standards. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

As previously reported in the Company's Annual Report on Form 10-K, as of December 31, 2004, the Company noted two material weaknesses in its internal controls over financial reporting. As of June 30, 2005, the Company had remediated one of the material weaknesses and had implemented new controls to address the other material weakness. As of September 30, 2005, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were not effective due to the remaining material weakness in its internal controls over financial reporting. The material weaknesses as of December 31, 2004 and the Company's completed and continuing remediation of such weaknesses are described below.

As of December 30, 2004:

1. We identified a material weakness for insufficient controls over the review, approval, and accounting for stock option modifications in connection with employee terminations. In January 2005, management instituted a control procedure which requires non-standard terminations of personnel to be reviewed and approved by our legal and finance organizations. The Company has evaluated the operating effectiveness of this control and believes that this material weakness was remediated as of June 30, 2005.
2. We identified the following insufficient internal controls, which relate to certain areas of our financial statement close process and constitute a material weakness in the aggregate.
 - a. Insufficient controls over the preparation and review of the Company's spreadsheet detail used to account for prepaid commissions.
 - b. Insufficient controls over the review and accounting for a third party services consulting payment.
 - c. Insufficient controls over the classification of auction rate securities as cash equivalents on the balance sheet due to management's reliance on its broker statements which lacked sufficient details to identify such securities.

In the first quarter of 2005, we supplemented our financial statement close process by adding additional review procedures to address the identified deficiencies. The Company believes the additional controls will be effective in remediating this material weakness. We have monitored the operating effectiveness of these controls from the time of implementation through September 30, 2005 and plan to continue to evaluate these controls during the remainder of 2005.

Changes in internal control over financial reporting.

Other than the changes described above there was no significant change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) identified in connection with the evaluation described above that occurred during the period covered by this quarterly report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II: OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

Between December 9, 2004 and January 21, 2005, several purported securities class action suits were filed in the United States District Court for the Northern District of California against the Company, its CEO, Radha R. Basu, and its CFO, Brian M Beattie. These actions were consolidated on March 22, 2005 as *In re SupportSoft, Inc. Securities Litigation*, Civil Action No.: c 04-5222 SI. The consolidated complaint alleges generally violations of certain federal securities laws and seek unspecified damages on behalf of a class of purchasers of the Company's common stock between January 20, 2004 and October 1, 2004. Plaintiffs allege, among other things, that defendants made false and misleading statements concerning the Company's business and guidance for the third quarter 2004, purportedly violating Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. On July 15, 2005, the Court granted our motion to dismiss the Complaint with leave to amend the Complaint. The plaintiffs filed their First Amended Complaint on August 19, 2005. On September 23, 2005, we moved to dismiss the First Amended Complaint and the hearing on this motion is set for November 18, 2005. While we cannot predict with certainty the outcome of the litigation, we believe that the claims against us and our officers are without merit.

In November 2001, a class action lawsuit was filed against us and two of our officers in the United States District Court for the Southern District of New York. The lawsuit alleged that our registration statement and prospectus dated July 18, 2000 for the issuance and initial public offering of 4,250,000 shares of our common stock contained material misrepresentations and/or omissions, related to alleged inflated commissions received by the underwriters of the offering. The defendants named in the lawsuit are SupportSoft, Radha Basu, Brian Beattie, Credit Suisse First Boston Corporation, Bear, Stearns & Co. Inc. and FleetBoston Robertson Stephens Inc. The lawsuit seeks unspecified damages as well as interest, fees and costs. Similar complaints have been filed against 55 underwriters and more than 300 other companies and other individual officers and directors of those companies. All of the complaints against the underwriters, issuers and individuals have been consolidated for pre-trial purposes before U.S. District Court Judge Scheindlin of the Southern District of New York. On June 26, 2003, the plaintiffs announced that a proposed settlement between the issuer defendants and their directors and officers had been reached. As a result of the proposed settlement, which is subject to court approval, we anticipate that our insurance carrier will be responsible for any payments other than attorneys' fees prior to June 1, 2003. At a court conference on March 4, 2004, plaintiffs' executive committee advised the court that the negotiators for plaintiffs and issuers have agreed on the terms of the settlement. During mid-2004, the plaintiffs moved for preliminary approval of the proposed settlement. After full briefing and argument, on February 15, 2005, the court issued an opinion preliminarily approving the proposed settlement, contingent upon modifications being made to one aspect of the proposed settlement—the proposed “bar order”. At a further conference on April 13, 2005, the court set a further schedule for submission of documents concerning the form and substance of class notice, and tentatively set a Rule 23 public hearing on the fairness of the proposed settlement for January 9, 2006. On August 31, 2005, the court issued an order preliminarily approving the settlement and setting a public hearing on its fairness for April 24, 2006 (the postponement from January 2006 to April 2006 was because of difficulties in mailing the required notice to class members). On October 27, 2005, the court issued an order making some minor changes to the form of notice to be sent to class members. While we cannot predict with certainty the outcome of the litigation or whether the settlement will be approved, we believe that the claims against us and our officers are without merit.

We are also subject to other routine legal proceedings, as well as demands, claims and threatened litigation, that arise in the normal course of our business. The ultimate outcome of any litigation is uncertain, and either unfavorable or favorable outcomes could have a material negative impact. Regardless of outcome, litigation can have an adverse impact on SupportSoft because of defense costs, diversion of management resources and other factors.

ITEM 6. EXHIBITS.

Exhibits.

31.1 Chief Executive Officer Section 302 Certification.

31.2 Chief Financial Officer Section 302 Certification.

32.1 Statement of the Chief Executive Officer under 18 U.S.C. § 1350¹

32.2 Statement of the Chief Financial Officer under 18 U.S.C. § 1350¹

¹ The certifications filed as Exhibits 32.1 and 32.2 are not deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934 and are not to be incorporated by reference into any filing of the Company under the Securities Exchange Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof irrespective of any general incorporation by reference language contained in any such filing, except to the extent that the registrant specifically incorporates it by reference.

**EXHIBIT INDEX TO SUPPORTSOFT, INC.
QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2005**

Exhibit Number	Description
31.1	Chief Executive Officer Section 302 Certification.
31.2	Chief Financial Officer Section 302 Certification.
32.1	Statement of the Chief Executive Officer under 18 U.S.C. § 1350 ¹
32.2	Statement of the Chief Financial Officer under 18 U.S.C. § 1350 ¹

¹ The certifications filed as Exhibits 32.1 and 32.2 are not deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934 and are not to be incorporated by reference into any filing of the Company under the Securities Exchange Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof irrespective of any general incorporation by reference language contained in any such filing, except to the extent that the registrant specifically incorporates it by reference.

STATEMENT OF CHIEF EXECUTIVE OFFICER UNDER 18 U.S.C. § 1350

I, Radha R. Basu, the chief executive officer of SupportSoft, Inc. (the "Company"), certify for the purposes of section 1350 of chapter 63 of title 18 of the United States Code that, to the best of my knowledge,

- (i) the Quarterly Report of the Company on Form 10-Q for the quarter ended September 30, 2005 (the "Report"), fully complies with the requirements of section 13(a) of the Securities Exchange Act of 1934, and
- (ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 8, 2005

/s/ RADHA R. BASU

Radha R. Basu
Chief Executive Officer and President

A signed original of this written statement required by 18 U.S.C. § 1350 has been provided to SupportSoft, Inc. and will be retained by SupportSoft, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

¹ The material contained in this Exhibit 32.1 is not deemed "filed" with the SEC and is not to be incorporated by reference into any filing of the Company under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language contained in such filing, except to the extent that the registrant specifically incorporates it by reference.

STATEMENT OF CHIEF FINANCIAL OFFICER UNDER 18 U.S.C. § 1350

I, Brian M. Beattie, the chief financial officer of SupportSoft, Inc. (the “Company”), certify for the purposes of section 1350 of chapter 63 of title 18 of the United States Code that, to the best of my knowledge,

- (i) the Quarterly Report of the Company on Form 10-Q for the quarter ended September 30, 2005 (the “Report”), fully complies with the requirements of section 13(a) of the Securities Exchange Act of 1934, and
- (ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 8, 2005

/s/ BRIAN M. BEATTIE

Brian M. Beattie
Executive Vice President of Finance
and Administration and Chief Financial Officer

A signed original of this written statement required by 18 U.S.C. § 1350 has been provided to SupportSoft, Inc. and will be retained by SupportSoft, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

¹ The material contained in this Exhibit 32.2 is not deemed “filed” with the SEC and is not to be incorporated by reference into any filing of the Company under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language contained in such filing, except to the extent that the registrant specifically incorporates it by reference.