
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, 2006

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. 0-24607

Actuate Corporation

(Exact name of Registrant as specified in its charter)

Delaware
(State of incorporation)

94-3193197
(I.R.S. Employer Identification No.)

701 Gateway Boulevard
South San Francisco, California 94080
(650) 837-2000

(Address, including zip code, and telephone number,
including area code, of Registrant's principal executive offices)

Former name, former address and former fiscal year, if changed since last report: None

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

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

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

Title of Class	Outstanding as of September 30, 2006
Common Stock, par value \$.001 per share	60,234,593

[Table of Contents](#)

Actuate Corporation

Table of Contents

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)	3
Condensed Consolidated Balance Sheets as of September 30, 2006 and December 31, 2005	3
Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2006 and 2005	4
Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2006 and 2005	5
Notes to Condensed Consolidated Financial Statements	6
Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations	20
Item 3. Quantitative and Qualitative Disclosures about Market Risk	31
Item 4. Controls and Procedures	31

PART II - OTHER INFORMATION

Item 1. Legal Proceedings	31
Item 1A. Risk Factors	32
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	41
Item 6. Exhibits	42
Signature	43

[Table of Contents](#)

Part I. Financial Information

Item 1. Financial Statements

ACTUATE CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands except share and per share data)

(unaudited)

	September 30,	December 31,
	2006	2005
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 15,340	\$ 12,490
Short-term investments	32,157	41,907
Accounts receivable, net of allowance of \$1,138 and \$1,318 at September 30, 2006 and December 31, 2005, respectively	27,945	26,798
Other current assets	4,369	2,911
Total current assets	79,811	84,106
Property and equipment, net	4,612	4,716
Goodwill	31,105	20,990
Other purchased intangibles, net	6,082	1,139
Other assets	839	630
	<u>\$ 122,449</u>	<u>\$ 111,581</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,540	\$ 2,101
Current portion of restructuring liabilities	2,887	2,948
Accrued compensation	4,275	5,306
Other accrued liabilities	3,678	3,108
Income taxes payable	256	279
Deferred revenue	34,972	31,475
Total current liabilities	47,608	45,217
Long-term liabilities:		
Other long-term liabilities	102	198
Long-term deferred revenue	1,465	913
Restructuring liabilities and others, less current portion	8,494	9,885
Total long-term liabilities	10,061	10,996
Stockholders' equity:		
Preferred stock, \$0.001 par value, issuable in series: 5,000,000 shares authorized; none issued and outstanding	—	—
Common stock, \$0.001 par value, 100,000,000 shares authorized; issued 68,531,927 and 67,536,651 shares, respectively; outstanding 60,234,593 and 60,170,503 shares, respectively	60	60
Additional paid-in capital	117,663	108,904
Treasury stock, at cost; 8,297,334 and 7,366,148 shares, respectively	(22,178)	(18,691)
Accumulated other comprehensive loss	(43)	(555)
Accumulated deficit	(30,722)	(34,350)
Total stockholders' equity	64,780	55,368
	<u>\$ 122,449</u>	<u>\$ 111,581</u>

The accompanying notes are an integral part of these condensed consolidated financial statements.

[Table of Contents](#)

ACTUATE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended		Nine months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Revenues:				
License fees	\$ 11,585	\$ 8,894	\$ 32,756	\$ 26,647
Services	20,344	17,951	60,689	50,593
Total revenues	31,929	26,845	93,445	77,240
Costs and expenses:				
Cost of license fees (1)	465	489	1,431	1,804
Cost of services (1)	6,788	5,702	21,387	17,271
Sales and marketing (1)	11,879	9,411	35,586	26,564
Research and development (1)	5,166	4,011	15,776	12,370
General and administrative (1)	3,758	2,622	12,021	9,933
Amortization of other purchased intangibles	237	17	711	487
In-process research and development	—	—	900	—
Restructuring charges	16	4	16	751
Total costs and expenses	28,309	22,256	87,828	69,180
Income from operations	3,620	4,589	5,617	8,060
Interest and other income, net	636	376	1,314	909
Income before income taxes	4,256	4,965	6,931	8,969
Provision for income taxes	1,745	1,225	3,303	1,507
Net income	\$ 2,511	\$ 3,740	\$ 3,628	\$ 7,462
Basic net income per share	\$ 0.04	\$ 0.06	\$ 0.06	\$ 0.12
Shares used in basic per share calculation	60,317	60,513	60,280	61,351
Diluted net income per share	\$ 0.04	\$ 0.06	\$ 0.05	\$ 0.12
Shares used in diluted per share calculation	66,157	62,313	66,191	63,366

(1) Includes stock based compensation expenses as follows:

Cost of license fees	\$ —	\$ —	\$ 2	\$ —
Cost of services	221	—	585	—
Sales and marketing	588	—	1,723	—
Research and development	316	—	909	—
General and administrative	565	—	1,579	—

The accompanying notes are an integral part of these condensed consolidated financial statements.

ACTUATE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands, unaudited)

	Nine months Ended	
	September 30,	
	2006	2005
Operating activities		
Net income	\$ 3,628	\$ 7,462
Adjustments to reconcile net income to net cash provided by operating activities:		
Stock based compensation expense related to stock options and employee stock purchase	4,798	—
Amortization of other purchased intangibles	1,478	1,286
Depreciation	1,265	1,538
Tax benefit from exercise of stock options	—	1,513
Unrealized investment loss	—	301
In-process research and development	900	—
Net operating loss utilizations related to prior acquisitions	464	—
Restructuring charges	16	751
Changes in operating assets and liabilities:		
Accounts receivable	(151)	4,210
Other current assets	1,463	(495)
Accounts payable	(3,360)	(153)
Accrued compensation	(1,550)	(1,244)
Other accrued liabilities	(99)	(2,024)
Deferred tax assets	(147)	—
Income taxes payable	(52)	(211)
Deferred rent liabilities	(130)	(90)
Restructuring liabilities	(1,468)	(3,018)
Deferred revenue	2,392	(1,278)
Net cash provided by operating activities	9,447	8,548
Investing activities		
Purchases of property and equipment	(671)	(136)
Proceeds from maturity of short-term investments	57,352	60,099
Purchases of short-term investments	(47,524)	(58,764)
Purchases of minority shares of Actuate Japan	(354)	—
Acquisition of performancesoft, Inc., net of cash acquired	(15,341)	—
Change in other current and non-current assets	(965)	(130)
Net cash provided by (used in) investing activities	(7,503)	1,069
Financing activities		
Tax benefit from exercise of stock options	1,898	—
Proceeds from issuance of common stock	2,061	1,667
Stock repurchases	(3,487)	(6,202)
Net cash provided by (used in) financing activities	472	(4,535)
Net increase in cash and cash equivalents	2,416	5,082
Effect of exchange rates on cash and cash equivalents	434	(157)
Cash and cash equivalents at the beginning of the period	12,490	7,341
Cash and cash equivalents at the end of the period	<u>\$ 15,340</u>	<u>\$ 12,266</u>

The accompanying notes are an integral part of these condensed consolidated financial statements.

ACTUATE CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying interim condensed consolidated financial statements of Actuate Corporation ("Actuate", the "Company", "We" or "Our") are unaudited and include all normal recurring adjustments and non-recurring adjustments which we believe to be necessary for the fair presentation of the financial position, results of operations, and changes in cash flows for the periods presented. The preparation of the financial statements in conformity with generally accepted accounting principles requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Despite our best effort to establish good faith estimates and assumptions, actual results may differ.

The interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2005 as filed with the Securities and Exchange Commission on March 13, 2006. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. Interim results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of operating results for any other future interim period or the full fiscal year.

Revenue Recognition

Actuate generates revenues from sales of software licenses and related services. The Company receives software license revenues from licensing its products directly to end-users and indirectly through resellers, system integrators and original equipment manufacturers ("OEMs"). The Company receives service revenues from maintenance contracts, consulting services and training that Actuate performs for customers.

Actuate recognizes revenues in accordance with AICPA Statement of Position ("SOP") 97-2 ("SOP 97-2"), "*Software Revenue Recognition*," as amended and modified by SOP 98-9, "*Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*." For sales to end-user customers, Actuate recognizes license revenues when a license agreement has been signed by both parties or a definitive agreement has been received from the customer, the product has been shipped, there are no unusual uncertainties surrounding the product acceptance, the fees are fixed or determinable, collectibility is probable and vendor-specific objective evidence of fair value exists to allocate the fee to the undelivered elements of the arrangement. Vendor-specific objective evidence is based on the price charged when an element is sold separately. Actuate has not established vendor-specific objective evidence of fair value for license fees. Therefore, the Company recognizes revenues from arrangements with multiple elements involving software licenses under the residual method. If the license agreement contains payment terms that would indicate that the fee is not fixed or determinable, revenues are recognized as the payments become due and payable, assuming that all other revenue recognition criteria are met.

Actuate enters into reseller and distributor arrangements that typically give such distributors and resellers the right to distribute its products to end-users headquartered in specified territories. Actuate recognizes license revenues from arrangements with U.S. resellers and distributors when there is persuasive evidence of an arrangement with the reseller or distributor, the product has been shipped, the fees are fixed or determinable and collectibility is probable. Actuate recognizes license revenues from arrangements with international resellers and distributors upon receipt of evidence of sell-through and when all other revenue recognition criteria have been met. If it is not practical to obtain evidence of sell-through, the Company defers revenues until the end-user has been identified and cash has been received. In some instances there is a timing difference between when a reseller completes its sale to the end-user and the period in which Actuate receives the documentation required for revenue recognition. Because Actuate delays revenue recognition until the reporting period in which the required documentation is obtained, it may recognize revenue in a period subsequent to the period in which the reseller completes the sale to its end-user.

Actuate also enters into OEM arrangements that provide for license fees based on the bundling or embedding of its products with the OEMs' products. These arrangements generally provide for fixed, irrevocable royalty payments. Actuate recognizes license fee revenues from U.S. and International OEM arrangements when a license agreement has been executed by both parties, the product has been shipped, there are no unusual uncertainties surrounding the product acceptance, the fees are fixed or determinable, collectibility is probable and vendor-specific objective evidence of fair value exists to allocate the fee to the undelivered elements of the arrangement. Effective July 1, 2006, we changed our policy for sales through

Table of Contents

international OEMs to be consistent with U.S. OEM arrangements. Prior to this change, we deferred revenue on sales through international OEMs until we received a royalty report or other evidence of sell-through from such OEM, assuming all other revenue recognition criteria was met. The impact of this change on revenue for the third quarter of fiscal year 2006 was not significant.

Credit-worthiness and collectibility for end-users are assessed based on payment history and current credit profile. When a customer is not deemed credit-worthy, revenues are deferred and recognized upon cash receipt.

Actuate recognizes maintenance revenues, which consist of fees for ongoing support and unspecified product updates, ratably over the term of the contract, typically one year. Consulting revenues are primarily related to standard implementation and configuration. Training revenues are generated from classes offered at the Company's headquarters and customer locations. Revenues from consulting and training services are recognized as the services are performed. When a contract includes both, license and service elements, the license fee is typically recognized on delivery of the software, assuming all other revenue recognition criteria are met, provided services do not include significant customization or modification of the product and are not otherwise essential to the functionality of the software.

Adoption of SFAS 123(R)

The Company has various types of stock-based compensation plans. These plans are administered by the compensation committee of the Board of Directors, which selects persons to receive awards and determines the number of shares subject to each award and the terms, conditions, performance measures and other provisions of the award. Readers should refer to Note 9 of this document for additional information related to these stock-based compensation plans.

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "*Share-Based Payment*" ("SFAS 123(R)"), which requires companies to measure and recognize compensation expense for all stock-based payments at fair value. Prior to the adoption of SFAS 123R, the Company accounted for its stock-based compensation plans under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, and accordingly, recognized no compensation expense related to the stock-based plans as options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

The Company has elected to adopt the modified prospective transition method permitted by SFAS 123(R), which applies to new awards and to awards that were outstanding on January 1, 2006 that are subsequently modified, repurchased or cancelled. Under the modified prospective approach, compensation cost recognized for the first nine months of fiscal year 2006 includes compensation cost for all share-based payments granted prior to, but not yet vested as of, January 1, 2006. This cost is based on the grant-date fair value estimated at the time of the grant, in accordance with the pro forma provisions of SFAS 123. Compensation cost for all share-based payments granted subsequent to January 1, 2006, are based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Accordingly, prior periods were not restated to reflect the impact of adopting the new standard. The fair value of option awards is estimated on the date of grant using the Black-Scholes-Merton option pricing model.

As a result of adopting SFAS 123R on January 1, 2006, the Company's income before income taxes for the three and nine months ended September 30, 2006 was lower by \$1.7 and \$4.8 million, respectively, than if it had continued to account for share-based compensation under APB 25. Also, net income for the three and nine months ended September 30, 2006 was lower by \$2.2 and \$5.9 million, respectively, than if it had continued to be accounted for under APB 25. Basic and diluted net income per share for the three months ended September 30, 2006 would have been \$0.08 and \$0.07, respectively, if the Company had not adopted SFAS 123R. Basic and diluted net income per share for the nine months ended September 30, 2006 would have been \$0.16 and \$0.14, respectively, if the Company had not adopted SFAS 123R.

Stock-Based Compensation

Prior to the adoption of SFAS 123(R), we accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, "*Accounting for Stock-Based Compensation*" ("SFAS 123"). Under the intrinsic value method, no stock-based compensation

[Table of Contents](#)

expense for employee stock options had been recognized in our Consolidated Statements of Operations, because the exercise price of our stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

The table below reflects pro forma net income and net income per share for the three and nine months ended September 30, 2005 as if the Company had accounted for its stock options using the fair value method (in thousands, except income per share amounts):

	September 30, 2005	
	Three months ended	Nine months ended
Net income - as reported	\$ 3,740	\$ 7,462
Less: Stock-based employee compensation expense determined under the fair value method for all awards, net of tax	(1,476)	(4,368)
Net income - pro forma	\$ 2,264	\$ 3,094
Net income per share:		
Basic - as reported	\$ 0.06	\$ 0.12
Basic - pro forma	\$ 0.04	\$ 0.05
Diluted - as reported	\$ 0.06	\$ 0.12
Diluted - pro forma	\$ 0.04	\$ 0.05

The fair value of each option award and stock purchase right under our Employee Stock Purchase Plan is estimated on the date of grant using the Black-Scholes-Merton option pricing model. We estimate the expected term of options granted by analyzing actual historical experience of exercises and cancellations under our plan. We also look at the average length of time in which our current outstanding options are expected to be exercised or cancelled based on past experience and the vesting and contractual term. We estimate the volatility of our common stock by using historical volatility over the calculated expected term. We base the risk-free interest rate that we use in the option valuation model on the published Treasury rate. We do not anticipate paying any cash dividends in the foreseeable future and therefore use an expected dividend yield of zero in the option valuation model.

Under SFAS 123R we estimate forfeitures when recognizing compensation expense, and we will adjust our estimate of forfeitures over the requisite service period based on the extent to which actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change and will also impact the amount of compensation expense to be recognized in future periods.

The assumptions used to estimate the fair value of stock options granted and stock purchase rights granted under our Employee Stock Purchase Plan for the three and nine months ended September 30, 2006 and 2005 are as follows:

	Options		ESPP	
	Three Months Ended		Three Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Volatility	83.57%	78.70%	46.05%	45.19%
Expected term (years)	4.5	3.0	0.5	0.5
Risk free interest rate	4.50%	4.13%	5.08%	3.87%
Expected dividend yield	0 %	0 %	0 %	0 %
Forfeiture rate	4 %	N/A	N/A	N/A

[Table of Contents](#)

	Options		ESPP	
	Nine months Ended		Nine months Ended	
	September 30,	September 30,	September 30,	September 30,
	2006	2005	2006	2005
Volatility	83.57 - 86.82%	78.70 - 97.38%	42.58 - 46.05%	45.19 - 46.36%
Expected term (years)	4.16 - 4.5	3.0	0.5	0.5
Risk free interest rate	4.50 - 4.88%	3.38 - 4.13%	4.68 - 5.08%	3.03 - 3.87%
Expected dividend yield	0%	0%	0%	0%
Forfeiture rate	4%	N/A	N/A	N/A

As of September 30, 2006, there was approximately \$6.8 million of unrecognized compensation cost, adjusted for estimated forfeitures, related to non-vested stock options granted to Actuate employees. These compensation expenses will be recognized over the appropriate amortization period of four years using the accelerated amortization method as provided under Financial Accounting Standards Board Interpretation Number 28, “*Accounting for Stock Appreciation Rights and Other Variable Stock Option or Awards Plans*” (“FIN 28”). Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures.

Net Income Per Share

Basic net income per share has been computed using the weighted-average number of shares of common stock outstanding during the period. Diluted net income per share is computed using the weighted-average number of common and dilutive common equivalent shares outstanding during the period. Common equivalent shares consist of the shares issuable upon the exercise of stock options using the treasury stock method.

The table below reconciles the weighted average common shares used to calculate basic net income per share with the weighted-average common shares used to calculate diluted net income per share (in thousands):

	Three Months Ended		Nine months Ended	
	September 30,	September 30,	September 30,	September 30,
	2006	2005	2006	2005
Weighted-average common shares outstanding	60,317	60,513	60,280	61,351
Weighted-average dilutive stock options outstanding under the treasury stock method	5,840	1,800	5,911	2,015
Weighted-average common shares used in computing diluted net income per share	66,157	62,313	66,191	63,366

We generated net income for the three and nine month periods ended September 30, 2006. Under the treasury stock method, stock options with exercise prices exceeding the average share price of our Company’s common stock during the applicable period are excluded from the diluted earnings per share computation. The weighted-average number of shares excluded from the calculation of diluted net income was 4,932,307 and 4,679,932 in the three and nine months ended September 30, 2006, respectively. We also generated net income for the three and nine month periods ending September 30, 2005. The weighted-average number of shares excluded from the calculation of diluted net income was 11,310,843 and 11,390,971 in the three and nine months ended September 30, 2005, respectively. These anti-dilutive options could be dilutive in future periods.

The weighted average exercise price of excluded stock options was \$4.96 and \$5.03 for the three and nine months ended September 30, 2006, respectively. The weighted average exercise price of excluded stock options was \$3.84 and \$3.87 for the three and nine months ended September 30, 2005, respectively.

[Table of Contents](#)

Comprehensive Income (Loss)

Other comprehensive income (loss) includes currency translation adjustments and unrealized gains and losses on short-term investments that are not included in net income, but rather are recorded directly in stockholders' equity. The following table represents changes in the components of accumulated other comprehensive income (loss) for the three and nine months ended September 30, 2006 and 2005, respectively, (in thousands):

	Three Months Ended		Nine months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Net income	\$ 2,511	\$ 3,740	\$ 3,628	\$ 7,462
Foreign currency translation adjustment gain (loss)	91	(77)	434	(98)
Unrealized gain (loss) on available-for-sale-securities	47	(31)	78	(35)
Total comprehensive income	<u>\$ 2,649</u>	<u>\$ 3,632</u>	<u>\$ 4,140</u>	<u>\$ 7,329</u>

Recent Accounting Pronouncements

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when quantifying Misstatements in Current Year Financial Statements* ("SAB 108"). SAB 108 requires companies to evaluate the materiality of identified unadjusted errors on each financial statement and related financial statement disclosure using both the rollover approach and the iron curtain approach. The rollover approach quantifies misstatements based on the amount of the error in the current year financial statement whereas the iron curtain approach quantifies misstatements based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatement's year(s) of origin. Financial statements would require adjustment when either approach results in quantifying a misstatement that is material. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. SAB 108 is effective for interim periods of the first fiscal year ending after November 15, 2006. The Company is currently evaluating the impact of SAB 108 on its consolidated results of operations and financial position.

In June 2006, the FASB ratified the consensus on Emerging Issues Task Force (EITF) Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement*. (EITF 06-03). The scope of EITF 06-03 includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but is not limited to, sales, use, value added, Universal Service Fund (USF) contributions and some excise taxes. The Task Force affirmed its conclusion that entities should present these taxes in the income statement on either a gross or a net basis, based on their accounting policy, which should be disclosed pursuant to APB Opinion No. 22, *Disclosure of Accounting Policies*. If such taxes are significant, and are presented on a gross basis, the amounts of those taxes should be disclosed. The consensus on EITF 06-03 will be effective for interim and annual reporting periods beginning after December 15, 2006. The Company does not anticipate a significant impact from EITF 06-03 on its consolidated results of operations and financial condition.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109* ("FIN 48"). This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This interpretation prescribes that a company should use a more-likely-than-not recognition threshold based on the technical merits of the tax position taken. Tax positions that meet the more-likely-than-not recognition threshold should be measured in order to determine the tax benefit to be recognized in the financial statements. FIN 48 is effective in fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of FIN 48 on its consolidated results of operations and financial condition.

2. Acquisition of performancesoft, Inc.

In January of fiscal year 2006, the Company acquired all of the outstanding shares of capital stock of performancesoft, Inc. ("performancesoft"). performancesoft was a privately-held entity headquartered in Toronto, Canada, and a leading provider of performance management solutions software and services. The transaction was accounted for using the purchase method of accounting in accordance with Statement of Financial Accounting Standards No. 141 ("SFAS 141"), "Business Combinations." performancesoft provides a total performance management solution that helps organizations measure their performance, manage their business, and helps them achieve more effective decision-making, efficient management reporting and increased accountability. The Company acquired performancesoft for the purpose of enhancing its current product offering by adding performancesoft's products and technology to its existing product line. The Company began including the operating results of performancesoft in its consolidated financial statements from the closing date of the acquisition, which was January 5, 2006.

The acquisition principally consisted of an initial cash purchase price of \$15.5 million and additional contingent cash consideration of up to \$13.5 million based on the achievement of certain revenue and operating margin targets for fiscal year

2006. This contingent consideration would be payable in fiscal year 2007. Due to the fact that the contingent consideration is currently not determinable beyond a reasonable doubt, the Company did not include this contingent consideration in the

[Table of Contents](#)

acquisition accounting at the date of acquisition. Rather, it will be recorded when the contingency is resolved in 2007. At that time, the Company will record the current fair value of any additional consideration as additional cost of the acquired enterprise. We expect that this additional cost would be allocated to goodwill.

In addition to the \$15.5 million initial cash payment, the Company put \$1.0 million in cash in escrow related to this transaction. This additional payment was paid into an escrow account pending the resolution of specific items documented in the purchase agreement. The Company did not initially include this \$1.0 million in the purchase price as the amount to be released from escrow was not determinable beyond a reasonable doubt. As of September 30, 2006 the entire \$1.0 million balance is classified in the other current assets line on the balance sheet. In October 2006, Actuate signed an agreement with the former shareholders of performancesoft to resolve the pending items on which this \$1.0 million payment depends. As a result of this agreement, the Company and the former shareholders agreed that of the \$1.0 million still residing in escrow, \$675,000 would be returned to Actuate and the remaining \$325,000 would be released to the former shareholders as further consideration for the acquisition. Since these pending items have now been resolved, Actuate will add the additional \$325,000 to the purchase price of the performancesoft acquisition in the fourth quarter of fiscal year 2006.

Assets acquired and liabilities assumed were recorded at their fair values as of January 5, 2006. The total \$15.6 million initial purchase price is comprised of the following:

Cash	\$ 15,564,801
Direct transaction costs	92,044
Total initial purchase price	<u>\$ 15,656,845</u>

Direct transaction costs of \$92,044 include legal and accounting fees, appraisal fees, and other external costs directly related to the acquisition.

Purchase Price Allocation

In accordance with SFAS No. 141, the total preliminary purchase price was allocated to performancesoft's net tangible liabilities and identifiable intangible assets based upon their estimated fair values as of January 5, 2006. The excess purchase price over the value of the net tangible liabilities and identifiable intangible assets was recorded as goodwill. We determined the valuation of our identifiable intangible assets with the assistance of a third party valuation firm. The following represents the preliminary allocation of the initial purchase price to the acquired net assets of performancesoft and the associated estimated useful lives (in thousands):

	<u>Amount</u>	<u>Estimated Useful Life</u>
Net tangible assets and liabilities:		
Accounts receivable, net	\$ 996	N/A
Recoverable income tax	1,595	N/A
Accounts payable	(1,665)	N/A
Deferred revenue	(1,657)	N/A
Other net assets and liabilities	178	N/A
	<u>(553)</u>	N/A
Identifiable intangible assets:		
Existing technology	1,100	5 years
Customer and partner relationships	3,400	5 years
In-process research and development	900	N/A
Tradename	800	3 years
Goodwill	<u>10,010</u>	N/A
Total initial purchase price	<u>\$ 15,657</u>	

Identifiable intangible assets—Existing technology includes developed technology related primarily to performancesoft's main product, Views. The value of existing technology was determined using the excess earnings approach. The excess earnings approach considers the earnings attributable to a specific intangible asset of a company to be those earnings in excess of fair returns on all of the contributory assets that are necessary to realize the earnings.

Customer contracts and relationships represent existing customer and partner relationships. The value of these relationships was determined using the cost savings method, which is an income approach methodology.

[Table of Contents](#)

Tradenames primarily relate to the performancesoft name and the Views product name. The value of the tradenames was determined using a relief-of-royalty method of the income approach. Under this method the value of an intangible asset is determined by quantifying the cost savings a company enjoys by owning, as opposed to licensing, the intangible asset.

In-process research and development—As of the acquisition date, \$900,000 was allocated to in-process research and development. In-process research and development is dependent on the status of new projects on the date the acquisition is consummated. At the date of acquisition the acquired company had two development projects that were in process, relating to its Views product and a new product offering called Track. Both of these projects were completed by the end of the third quarter of fiscal year 2006. The value of in-process research and development was determined using the excess earnings approach. The discount rates used were 18% to 19% and they take into consideration the stage of completion and the risk surrounding the successful development and commercialization of each of the purchased in-process technology projects that were valued. The Company expensed the total value of these in-process research and development projects at the time of acquisition as they were determined to have no alternative future use. This expense is shown as a separate line item in the condensed consolidated statement of operations.

Goodwill—Approximately \$10.0 million has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the underlying net tangible and intangible assets. In accordance with SFAS 142, goodwill will not be amortized but instead will be tested for impairment at least annually (more frequently if certain indicators are present).

In connection with the performancesoft acquisition, Actuate's Board of Directors duly authorized the issuance of stock options to eligible employees from the Company's 1998 Equity Incentive Plan. A total of 530,200 non-statutory stock options were issued in January of 2006 at an exercise price of \$3.36. Each grant shall fully vest in four years with 25% vesting at the end of year one and the remaining balance to vest in thirty-six equal successive monthly installments. These shares were valued at their fair value in accordance with SFAS 123R and are being amortized over their vesting period using the accelerated amortization method as provided under Financial Accounting Standards Board Interpretation Number 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Awards Plans" ("FIN 28").

Pro Forma Results

The unaudited financial information in the table below summarizes the combined results of operations of Actuate and performancesoft, on a pro forma basis, as though the companies had been combined as of the beginning of the period presented. The pro forma financial information is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisition had taken place on January 1, 2005 or of results that may occur in the future.

The unaudited pro forma financial information for the year ended December 31, 2005 combines the historical results for Actuate for the twelve months ended December 31, 2005 and the historical results for performancesoft for the twelve months ended October 31, 2005. We have not presented pro forma results for fiscal year 2006 as any differences from the 2006 actual results would be immaterial, due to the timing of the acquisition.

	Year Ended	
	December 31, 2005	
	(in thousands, except per share data)	
	(Unaudited)	
	As Reported	Proforma
Total revenues	\$ 106,401	\$ 120,143
Net income	\$ 11,591	\$ 11,809
Basic net income per share	\$.19	\$.19
Diluted net income per share	\$.18	\$.19

3. Investment in Actuate Japan

The minority shareholders of Actuate Japan have the option to put their equity interest ("Minority Interest") in Actuate Japan and Actuate has the option to call the Minority Interest. In February 2006, a minority shareholder of Actuate Japan notified the Company that it wished to exercise its right to put its equity interest in Actuate Japan. This minority shareholder exercised its right on March 15, 2006 resulting in a payment of approximately \$354,000 for this interest during the first quarter of fiscal year 2006. This payment was recorded as additional goodwill related to Actuate Japan. The remaining minority interest as of September 30, 2006 was approximately 12%. If the minority interest shareholder chose to put these remaining shares, Actuate would be required to pay approximately \$411,000 to purchase these shares. As of the date of this filing, the remaining minority shareholder has not notified the Company of any intent to exercise their put option, and accordingly, the Company has not accounted for the potential exercise.

[Table of Contents](#)

4. Restructuring Charges

2004 Restructuring Plan

During fiscal year 2004, the Company underwent a restructuring that was carried out in two phases. The first occurred in the first quarter of fiscal year 2004 when the Company initiated a restructuring of its worldwide sales operations. This restructuring consisted primarily of a workforce reduction of approximately five people and associated severance benefits and related legal costs of \$586,000 during the first quarter of fiscal year 2004.

In early October 2004, Actuate implemented an additional restructuring. The costs associated with this restructuring totaled \$1.4 million in the fourth quarter of fiscal year 2004 and were primarily comprised of severance and related costs. The restructuring plan resulted in the elimination of approximately 9% of the Company's worldwide workforce or 53 positions across all levels and functions. The Company incurred additional expenditures of approximately \$665,000 during fiscal year 2005 related to this restructuring.

2002 Restructuring Plan

In response to the continuing global economic slowdown, Actuate developed a workforce reduction and a facility exit plan in the third quarter of fiscal year 2002. As a result of this restructuring plan, Actuate recorded a charge of \$27.1 million (consisting of a \$24.8 million idle facility charge and a \$2.3 million workforce reduction charge) in the third quarter of fiscal year 2002. The initial restructuring charges were based on assumptions and related estimates that were deemed appropriate for the economic environment that existed at the time these estimates were made.

Actuate initially recorded a charge of \$24.8 million related to the exit of its idle facility. The facility exit charge was calculated using management's best estimates and included \$21.5 million of estimated future obligations for non-cancelable lease payments (net of \$10.2 million of estimated sublease income) and estimated costs associated with subleasing the property (e.g., leasing commissions). The remaining \$3.3 million was related to the write-off of furniture and fixtures associated with the 801 Gateway facilities. Actuate made an adjustment of \$188,000 to increase this facility exit liability during the second quarter of fiscal year 2003. As of September 30, 2006, approximately \$10.9 million of lease exit costs, net of anticipated sublease income, remain accrued and are expected to be fully utilized by fiscal year 2011. In calculating the facility exit charge, certain assumptions were made relating to such factors as the estimated time periods of vacancy and sublease rates and opportunities. Our current calculations include an estimate of future sublease income. This estimate is comprised of current contractual future sublease income under existing arrangements, as well as an additional \$2.9 million of estimated sublease income. Actual future cash requirements may differ materially from the accrual at September 30, 2006, particularly if the actual sublease income is significantly different from current estimates or if the Company is unsuccessful in its efforts to sublease its facility. The facility exit charge also included a \$3.4 million write-off of property and equipment (primarily leaseholds improvements) as a result of the abandonment of leased facilities.

The following table summarizes the restructuring accrual activity during the nine months ended September 30, 2006 (in thousands):

	Severance	Facility	
	<u>& Benefits</u>	<u>Related</u>	<u>Total</u>
Balance at December 31, 2005	\$ 465	\$ 12,368	\$ 12,833
Cash payments, net of rents collected on sublease for Q1	(16)	(609)	(625)
Cash payments, net of rents collected on sublease for Q2	(4)	(335)	(339)
Changes in estimate (Q1 to Q3).	45	(29)	16
Cash payments, net of rents collected on sublease for Q3	(60)	(444)	(504)
	430	10,951	11,381
Less: current portion	(430)	(2,457)	(2,887)
Long-term portion at September 30, 2006	<u>\$ —</u>	<u>\$ 8,494</u>	<u>\$ 8,494</u>

5. Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

[Table of Contents](#)

The tax provision for the three and nine months ended September 30, 2006 and September 30, 2005 consists of federal, state and foreign income taxes and was computed based on the estimated annual effective tax rates applicable to such operations. The annual effective tax rate in fiscal year 2006 is higher due to higher projected domestic pre-tax income for 2006, which allows for the usage of NOL's and R&D tax credits, a higher effective tax as a result of adopting SFAS 123R and the write off of in-process R&D of \$900,000 treated as a discrete event. The book expenses as a result of SFAS 123R lowers our pre-tax net income, however, the amounts are not deductible for tax purposes, which produces a higher effective tax rate.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the historical income, projected future income, the expected timing of the reversals of existing temporary differences and the implementation of tax-planning strategies in making this assessment. Based upon the level of historical tax losses, management believes it is more likely than not that the Company will not realize a majority of the benefits of these deductible differences. Therefore, a valuation allowance has been established to offset the deferred tax assets where these benefits may not be realized.

The Company, however, may determine it will be able to realize all or a portion of its deferred tax assets in the U.S. in the foreseeable future. Upon such determination a reduction in the valuation allowance related to its deferred tax assets would cause a material increase to net earnings in the period in which such determination is made. Significant management judgment is required in determining the period in which the reversal of a valuation allowance should occur. The Company considers all available evidence, both positive and negative, in making this determination, including historical income, projected future income, the expected timing of the reversals of existing temporary differences and the implementation of tax-planning strategies.

6. Geographic Information

Our primary operations are located in the United States. Revenues from international sources related to export sales, primarily to Europe and Asia. Our revenues by geographic area were as follows (in thousands):

	Three Months Ended		Nine months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Revenues:				
North America	\$ 24,322	\$ 20,815	\$ 71,554	\$ 59,736
Europe	6,168	4,561	18,475	13,858
Asia Pacific and others	1,439	1,469	3,416	3,646
	<u>\$ 31,929</u>	<u>\$ 26,845</u>	<u>\$ 93,445</u>	<u>\$ 77,240</u>

As of September 30, 2006, we operated solely in one reportable segment, which is the development, marketing and support of our Enterprise Reporting and performance management Application Platform. There were no customers that accounted for more than 10% of total revenues in the three and nine months ended September 30, 2006 or 2005. No customer accounted for more than 10% of our outstanding net accounts receivable balance at September 30, 2006.

7. Goodwill and Other Purchased Intangible Assets

Goodwill

In accordance with SFAS 142, the Company performs its annual impairment test of goodwill on October 1 of each year. The Company completed its annual assessment of goodwill on October 1, 2006, and no impairment of goodwill was determined as a result of this assessment. Following is a roll-forward of the activity that affected goodwill during the nine months ended September 30, 2006 (in thousands):

Goodwill as of December 31, 2005	\$ 20,990
Acquisition of performancesoft (preliminary purchase price allocation)	10,010
True-up purchase price allocation for performancesoft	184
Repurchase of Japan minority interest	354
Acquired net operating losses utilized	(433)
Goodwill as of September 30, 2006	<u>\$ 31,105</u>

[Table of Contents](#)

During the third quarter of fiscal year 2006, the Company made several revisions to the initial purchase price allocation related to the performance soft acquisition. These revisions resulted in a total net increase of \$184,000 to the performance soft goodwill balance.

Intangibles

Other purchased intangible assets consist of the following (in thousands):

	September 30, 2006			December 31, 2005		
	Gross			Gross		
	Carrying	Accumulated	Net Carrying	Carrying	Accumulated	Net Carrying
	Amount	Amortization	Amount	Amount	Amortization	Amount
Customer list	\$ 14,000	\$ (11,110)	\$ 2,890	\$ 10,600	\$ (10,600)	\$ —
Workforce	408	(408)	—	408	(408)	—
Purchased technologies	8,410	(5,818)	2,592	6,189	(5,050)	1,139
Non-compete agreements	1,030	(1,030)	—	1,030	(1,030)	—
Trademark	1,500	(900)	600	700	(700)	—
	<u>\$ 25,348</u>	<u>\$ (19,266)</u>	<u>\$ 6,082</u>	<u>\$ 18,927</u>	<u>\$ (17,788)</u>	<u>\$ 1,139</u>

As discussed further in Note 2, in January 2006, the Company acquired all of the outstanding shares of capital stock of performance soft. The total initial purchase price of \$15.6 million was allocated to various tangible and identifiable intangible assets, which consisted primarily of goodwill of \$10.2 million, purchased in-process research and development of \$900,000, trademark of \$800,000, customer and distribution relationship of \$3.4 million and core technology of \$1.1 million. The trademarks intangible asset is being amortized on a straight-line basis over a three year period, as the Company intends to phase out the use of the trademarks, while customer list and core technology is being amortized on a straight-line basis over five years. Purchased in-process research and development was expensed in the quarter ended March 31, 2006 as it had not reached technological feasibility and had no alternative future uses.

Amortization expense of purchased intangible assets was approximately \$509,000 and \$133,000 for the three months ended September 30, 2006 and 2005, respectively. Amortization expense of purchased intangible assets was approximately \$1.5 million and \$1.3 million for the nine months ended September 30, 2006 and 2005, respectively. These charges are included in cost of license fees and amortization of purchased intangibles in the accompanying condensed consolidated statements of operations. The expected remaining annual amortization expense is summarized as follows (in thousands):

	Purchased
	Technology and
	Intangibles
Fiscal Year	
2006 (remainder of year)	\$ 508
2007	2,031
2008	1,743
2009	900
2010	900
	<u>\$ 6,082</u>

In February 2006, a minority shareholder of Actuate Japan notified the Company that it wished to exercise its rights to put its equity interest in Actuate Japan. The Company paid approximately \$354,000 for this interest during the first quarter of fiscal year 2006. As a result of this payment the Company adjusted its investment in Actuate Japan and increased goodwill by the amount equal to the payment made on March 15, 2006.

[Table of Contents](#)

During the first nine months of the fiscal year 2006, the Company also made adjustments to goodwill and purchased technology related to the tax affected portion of the net operating losses (NOLs) utilized with respect to the Tidestone and Nimble acquisitions, respectively. These adjustments resulted in reductions of approximately \$433,000 and \$30,000 to the Company's goodwill and purchased intangibles balances, respectively. As of September 30, 2006, the carrying amount of the Company's goodwill was \$31.1 million.

Third Party Source Code

In December of 2005 Actuate agreed to purchase source code from a third-party technology vendor for \$1,150,000 in cash. Prior to this purchase, Actuate had been paying royalties to this vendor for the right to use and sell this underlying technology in its products. Under this purchase agreement, royalties are no longer required to be paid. The source code fee was capitalized as the product that the technology was embedded in had reached technological feasibility. The amount is being amortized to cost of license fees at the greater of 1) the ratio that current gross revenues for the associated product bear to the total current and estimated future gross revenues for that product, and 2) the straight-line method over the estimated three year economic life of the product.

8. Contingencies

General

We are engaged in certain legal actions arising in the ordinary course of business. Although there can be no assurance as to the outcome of such litigation, we believe we have adequate legal defenses and we believe that the ultimate outcome of any of these actions will not have a material effect on our consolidated financial position or results of operations.

9. Stock Benefit Plans

Stock Option Plans

Amended and Restated 1998 Equity Incentive Plan. In May 1998, the Board of Directors adopted the Amended and Restated 1998 Equity Incentive Plan (the "1998 Plan"), which was approved by the stockholders in July 1998. Employees, consultants and directors are eligible for awards under the 1998 Plan. Initially, a total of 5,200,000 shares of common stock were reserved for issuance under the 1998 Plan. As of January 1 of each year, the number of shares reserved for issuance under the 1998 Plan will be increased automatically by the lesser of (i) 5% of the total number of shares of common stock then outstanding or (ii) 2,800,000 shares. The 1998 Plan has been amended and restated to account for stock splits.

Under the 1998 Plan, eligible participants may be awarded options to purchase shares of common stock, stock appreciation rights ("SARs"), restricted shares or stock units (collectively, the "Awards"). Options under the 1998 Plan may be incentive stock options designed to satisfy Section 422 of the Internal Revenue Code of 1986, as amended (the "Code") or non-statutory stock options not designed to meet such requirements. If restricted shares or shares issued upon the exercise of options granted under the 1998 Plan are forfeited, then such shares will again become available for awards under the 1998 Plan. If stock units, options or SARs granted under the 1998 Plan are forfeited or terminated for any other reason before being exercised, then the corresponding shares will again become available for awards under the 1998 Plan. The exercise price for non-statutory and incentive stock options granted under the 1998 Plan may not be less than 85% or 100%, respectively, of the fair market value of the common stock on the option grant date. The Board may amend or terminate the 1998 Plan at any time. Amendments may be subject to stockholder approval to the extent required by applicable law.

Options granted under the 1998 Plan are exercisable when vested. Shares generally vest at the rate of 20% or 25% after one year from the date of grant and the remaining balance vests monthly over the next four or three years. Upon a change in control, an Award under the 1998 Plan will become fully vested as to all shares subject to such Award if such Award is not assumed by the surviving corporation or its parent and the surviving corporation or its parent does not substitute such Award with another award of substantially the same terms. In the event of an involuntary termination of a participant within 12 months following a change in control, the vesting of an Award under the 1998 Plan will accelerate in full. All outstanding repurchase rights under the 1998 Plan shall terminate automatically upon the occurrence of any merger, consolidation, or disposition of all or substantially all of the Company's assets, except to the extent the repurchase rights are expressly assigned to the successor corporation. As of September 30, 2006, 11,178,660 shares of common stock were reserved and available for future grants under the 1998 Option Plan.

2001 Supplemental Stock Plan. In January 2001, the Board of Directors adopted the 2001 Supplemental Stock Plan (the "2001 Plan"). A total of 2,700,000 shares of common stock were reserved for issuance under the 2001 Plan. Employees and consultants are eligible for awards under the 2001 Plan. Members of the Board of Directors and officers of Actuate are not eligible to receive awards under the 2001 Plan. Under the 2001 Plan, eligible participants may be awarded options to purchase shares of common stock and restricted shares only.

[Table of Contents](#)

All options granted under the 2001 Plan are non-statutory stock options. If restricted shares or shares issued upon the exercise of options granted under the 2001 Plan are forfeited, then such shares will again become available for awards under the 2001 Plan. The exercise price for non-statutory and incentive stock options granted under the 2001 Plan may not be less than 85% or 100%, respectively, of the fair market value of the common stock on the option grant date. The Board may amend or terminate the 2001 Plan at any time. Amendments may be subject to stockholder approval to the extent required by applicable law.

Options granted under the 2001 Plan are exercisable when vested. Shares generally vest at the rate of 25% after one year from the date of grant and the remaining balance vests monthly over the next four years. Upon a change in control, an Award under the 2001 Plan will become fully vested as to all shares subject to such Award if such Award is not assumed by the surviving corporation or its parent and the surviving corporation or its parent does not substitute such Award with another award of substantially the same terms. In the event of an involuntary termination of a participant within 12 months following a change in control, the vesting of an Award under the 2001 Plan will accelerate in full. All outstanding repurchase rights under the 2001 Plan shall terminate automatically upon the occurrence of any merger, consolidation, or disposition of all or substantially all of the Company's assets, except to the extent the repurchase rights are expressly assigned to the successor corporation. As of September 30, 2006, 689,704 shares of common stock were reserved and available for future grants under the 2001 Option Plan.

Tidestone Technologies Stock Option Plans. Tidestone Technologies, Inc.'s 1998 Incentive Stock Option Plan ("T-98 Option Plan") and Non-qualified Stock Option Plan of 1999 ("T-99 Option Plan") were assumed by the Company on May 30, 2001, in connection with the acquisition of Tidestone. The T-98 Option Plan and the T-99 Option Plan are collectively known as the "Tidestone Option Plans". Each option under the Tidestone Option Plans was converted into a right to receive an option to purchase shares of Actuate's common stock. A total of 77,968 and 70,509 shares of common stock have been authorized for issuance under the T-98 Option Plan and T-99 Option Plan, respectively.

All options granted under the T-98 Option Plan are incentive stock options qualified under Section 422 of the Code, with a vesting term of five years while the options granted under the T-99 Option Plan are non-statutory stock options with a vesting term of three years. Options granted under the Tidestone Option Plans are generally exercisable upon grant, subject to repurchase rights by us until vested. Under the T-99 Option Plan, shares generally vest at the rate 33% annually. Under the T-98 Option Plan, shares generally vest at the rate of 20% annually. Upon a change in control, an Award under the Tidestone Option Plans will become fully vested as to all shares subject to such Award if such Award is not assumed by the surviving corporation or its parent and the surviving corporation or its parent does not substitute such Award with another award of substantially the same terms. As of September 30, 2006, 31,987 and 2,055 shares of common stock were reserved and available for future grants under the T-98 Option and T-99 Option Plan, respectively.

1998 Non-Employee Director Option Plan. The 1998 Non-Employee Directors Option Plan (the "Directors Option Plan") was adopted by the Board of Directors in May 1998, and approved by the stockholders in July 1998. The Director Option Plan provides for non-employee members of the Board of Directors to be eligible for automatic option grants. 800,000 shares of common stock have been authorized for issuance under the Directors Option Plan. Each individual who first joins the Board as a non-employee director, whether through election or appointment, will receive at that time an automatic option grant for 80,000 shares of common stock. With respect to the initial automatic option grant, the option will become exercisable as to 25% of the shares after one year of Board service, with the balance of the shares becoming exercisable ratably in 36 monthly installments over the remaining period of optionee's Board service. At each annual stockholders' meeting beginning in fiscal year 1999, each current non-employee director will automatically be granted a stock option to purchase 10,000 shares of common stock, whether or not he or she is standing for re-election at that particular meeting, which will become fully vested and exercisable on the first anniversary of such meeting. Each option will have an exercise price equal to the fair market value of the common stock on the automatic grant date and a maximum term of ten years, subject to earlier termination following the optionee's cessation of Board service.

The Board may amend or modify the Directors Option Plan at any time. Amendments may be subject to stockholder approval to the extent required by law. The Directors Option Plan will terminate on the earlier of: May 27, 2008 or when all shares reserved for issuance have been issued, unless terminated sooner by the Board. However, vesting will automatically accelerate in full upon (i) an acquisition of Actuate by merger, consolidation or asset sale, (ii) a tender offer for more than 50% of the outstanding voting stock or proxy contest for Board membership or (iii) the death or disability of the optionee while serving as a Board member. As of September 30, 2006, 329,700 shares of common stock were reserved and available for future grants under the Directors Option Plan.

[Table of Contents](#)

Activity under all option plans was as follows:

	Outstanding Options			
	Shares		Price Per Share	Weighted-Average Exercise Price
	Available	Number of		
	For Grant	Shares		
Balance at December 31, 2005	11,573,471	19,292,404	\$ 0.16-\$31.19	\$ 2.83
Additional authorization	2,800,000	—	—	—
Options granted	(3,047,000)	3,047,000	\$ 3.65-\$4.27	\$ 3.88
Options exercised	—	(775,647)	\$ 0.31-\$4.14	\$ 2.09
Options forfeited	905,635	(905,635)	\$ 1.04-\$17.25	\$ 3.71
Balance at September 30, 2006	<u>12,232,106</u>	<u>20,658,122</u>	\$ 0.16-\$31.19	\$ 2.94

The weighted average grant date fair value of options granted during the quarter ended September 30, 2006 was \$2.54 per option. Upon the exercise of options, the Company issues new common stock from its authorized shares. The total intrinsic value of options exercised during the quarter ended September 30, 2006 was \$316,711.

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Weighted-Average			Weighted-Average	
	Number of	Remaining	Weighted-Average	Number of	Weighted-Average
	Shares	Contractual Life	Exercise Price	Shares	Exercise Price
\$0.16-\$1.25	380,788	1.21 years	\$0.63	380,767	\$0.63
\$1.27-\$1.49	6,772,810	6.07 years	\$1.49	6,712,351	\$1.49
\$1.56-\$2.99	4,853,853	7.77 years	\$2.57	2,499,676	\$2.60
\$3.00-\$3.68	4,130,957	6.81 years	\$3.53	1,718,108	\$3.53
\$3.71-\$31.19	4,519,714	5.73 years	\$5.17	3,803,738	\$5.37
\$0.16-\$31.19	<u>20,658,122</u>	6.46 years	\$2.94	<u>15,114,640</u>	\$2.86

At September 30, 2006, 20,369,635 options were vested and expected to vest, with an aggregate intrinsic value of \$34,974,705. The aggregate intrinsic value and weighted-average remaining contractual term of options currently exercisable at September 30, 2006 were \$28,363,885 and 5.63 years, respectively.

Amended and Restated 1998 Employee Stock Purchase Plan

The 1998 Amended and Restated Employee Stock Purchase Plan (the “Purchase Plan”) was adopted by the Board of Directors in May 1998, and approved by the stockholders in July 1998. A total of 1,000,000 shares of common stock were initially reserved for issuance under the Purchase Plan. On January 1 of each year, the number of shares reserved for issuance under the Purchase Plan is automatically increased by 600,000 shares. The Purchase Plan is intended to qualify under Section 423 of the Code. Each calendar year, two overlapping 24-month offering periods will commence on February 1 and August 1. Each offering period contains four six-month accumulation periods, with purchases occurring at the end of each six-month accumulation period. If the market price of Actuate’s stock at the end of any six-month purchase period is lower than the stock price at the original grant date, the plan is cancelled immediately after that purchase date. A new 24-month offering period is established using the then-current stock price as the base purchase price. The Purchase Plan permits each eligible employee to purchase common stock through payroll deductions, which may not exceed 15% of an employee’s cash compensation. Starting with the August 1, 2006 offering period, the amount of shares purchasable per accumulation period will be 1,000 shares per participant. The price of each share of common stock purchased under the Purchase Plan will be 85% of the lower of (i) the fair market value per share of common stock on the date immediately prior to the first date of the applicable offering period or (ii) the date at the end of the applicable accumulation period. Employees may end their participation in the Purchase Plan at any time during the accumulation period, and participation ends automatically upon termination of employment. The Purchase Plan has been amended and restated to account for stock splits. On July 29, 2006, the Company issued 122,702 common shares under the Purchase Plan, with a weighted-average purchase price of \$2.32. As of September 30, 2006, 4,559,056 shares had been purchased under the Purchase Plan and 1,240,944 shares of common stock were reserved and available for future issuance.

As of September 30, 2006, the number of shares of common stock reserved for future issuance under all option plans and the Purchase Plan was 13,473,050.

[Table of Contents](#)

10. Deferred Revenue

Deferred revenue consists of the following (in thousands):

	September 30,	December 31,
	2006	2005
Maintenance and support	\$ 30,224	\$ 24,948
Other	6,213	7,440
	\$ 36,437	\$ 32,388
Less: Current portion	(34,972)	(31,475)
Long-term deferred revenue	\$ 1,465	\$ 913

Maintenance and support consists of first year maintenance and support services associated with the initial purchase of Actuate's software, and the renewal of annual maintenance and support services from customers who purchased Actuate's software in prior periods. The maintenance and support period is generally 12 months and revenues are typically recognized on a straight-line basis over the term of the maintenance and support period.

Other deferred revenue consists of deferred license, training and consulting fees generated from arrangements, which did not meet some or all of the revenue recognition criteria of SOP No. 97-2 and are, therefore, deferred until all revenue recognition criteria have been met.

11. Subsequent Events

In January of 2006, Actuate paid an initial cash purchase price of \$15.5 million for the acquisition of performancesoft, Inc. In addition to this initial cash payment, the acquisition further consisted of an additional contingent cash consideration of up to \$13.5 million based on the achievement of certain revenue and operating margin targets for fiscal year 2006. Furthermore, Actuate paid \$1.0 million in additional cash at the time of acquisition to an escrow account pending the resolution of specific items documented in the purchase agreement. In October 2006, Actuate signed an agreement with the former shareholders of performancesoft. This agreement served to adjust the revenue and operating margin targets on which the contingent consideration is based. It also served to resolve the pending items on which the \$1.0 million payment depends. As a result of this agreement, the Company and the former shareholders agreed that of the \$1.0 million still residing in escrow, \$675,000 would be returned to Actuate and the remaining \$325,000 would be released to the former shareholders as further consideration for the acquisition. As of September 30, 2006, the entire \$1.0 million balance is classified in other current assets on the balance sheet. Since these pending items have now been resolved, Actuate will add the additional \$325,000 to the purchase price of the performancesoft acquisition in the fourth quarter of 2006.

In October 2006, the Board of Directors approved an on-going extension of the Company's stock repurchase program, which was originally announced in September 2001 and has been extended from time to time. This extension authorized management to make additional repurchases. Under this repurchase program, the Company is authorized to repurchase Actuate common stock at varying amounts, in an amount not to exceed cash flow from operations during the prior quarter. The actual amount to be repurchased is approved in advanced each quarter by the Board. From the end of the third quarter of fiscal year 2006 through November 8, 2006, the Company has repurchased a total of 29,988 shares in the open market under this repurchase plan for a value totaling approximately \$157,000.

[Table of Contents](#)

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

The following information should be read in conjunction with the historical financial information and the notes thereto included in Item 1 of this Quarterly Report on Form 10-Q and the consolidated financial statements and notes thereto and the related Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2005 as filed with the Securities and Exchange Commission on March 13, 2006.

The statements contained in this Form 10-Q that are not purely historical are forward looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, including statements regarding Actuate's expectations, beliefs, hopes, intentions, plans or strategies regarding the future. All forward-looking statements in this Form 10-Q are based upon information available to Actuate as of the date hereof, and Actuate assumes no obligation to update any such forward-looking statements. Actual results could differ materially from Actuate's current expectations. Factors that could cause or contribute to such differences include, but are not limited to, the risks discussed in Part II, Item 1A—Risk Factors of this Form 10-Q, and in other filings made by the Company with the Securities and Exchange Commission.

Overview

We are a leading provider of Enterprise Reporting and Performance Management Applications that empower 100% of users to achieve breakthrough corporate performance. We began shipping our first product in January 1996. Actuate's Enterprise Reporting Application Platform provides the most scalable, reliable, flexible and high-performing reporting capabilities for every application in the enterprise. Customers use Actuate to deliver information in context to users inside and outside the firewall as Customer Interaction and Operational Performance Reporting applications, managed spreadsheet applications and Java reporting applications. Actuate's performancesoft Suite helps high performing organizations drive strategy at all levels, improve decision making, and ensure better operational performance and execution. Organizations have benefited from performancesoft solutions to achieve better results utilizing a number of private and public sector Performance Management frameworks, including but not limited to: the Balanced Scorecard, Malcolm Baldrige, Six Sigma, JCAHO, and The President's Management Agenda.

In September 2006, we released and began shipping version 9 of the Actuate products. This Actuate 9 Collaborative Reporting Architecture combines open source technologies from the Eclipse Foundation BIRT (Business Intelligence and Reporting Tools) project with the scalability, performance, reliability and security of the Actuate iServer and the interactivity of AJAX (Asynchronous JavaScript and XML). With Actuate's Collaborative Reporting Architecture, companies can shift from a 'closed BI model' where information access and analysis is siloed, to an 'open BI model' that speeds report development by supporting collaboration among people of every skill level. Actuate 9 applies open source principles, including participation, iterative development and modularity, for the benefit of an organization's Business Intelligence initiatives. The Collaborative Reporting Architecture drives enterprise reporting costs down by leveraging the versatility of the Java development community, the speed and flexibility of Actuate's Information Object metadata layer, and a revolutionary reusable design structure that encourages collaboration among users of every skill level, for every reporting project.

We sell software products through two primary means: (i) directly to end-user customers through our direct sales force and (ii) indirectly through channel partners such as OEMs, resellers and system integrators. OEMs generally integrate our products with their applications and either provide hosting services or resell them with their products. Our other indirect channel partners resell our software products to end-user customers. Our total revenues are derived from license fees for software products and fees for services relating to such products, including software maintenance and support, consulting and training.

Our total revenues for the third quarter of fiscal 2006 were \$31.9 million, a 19%, or approximately \$5.1 million increase over the third quarter of fiscal 2005. This increase was primarily due to incremental revenue of \$3.2 million generated from new products associated with our acquisition of performancesoft in January 2006. Income from operations decreased from \$4.6 million, or 17% of total revenues, in the third quarter of fiscal year 2005 to \$3.6 million, or 11% of total revenues, in the third quarter of fiscal year 2006. This decline is primarily attributable to (i) the decline in operating margin as a result of the adoption of SFAS 123R, which resulted in the recognition of \$1.7 million in stock-based compensation for the third quarter of fiscal 2006, and (ii) the impact of the addition of performancesoft to the Company's total operations. These decreases were offset by the increases in revenues described above.

North American total revenues increased from \$20.8 million in the third quarter of fiscal year 2005 to \$24.3 million in the third quarter of fiscal year 2006. Revenues from international regions also increased from \$6.0 million in the third quarter of fiscal year 2005 to approximately \$7.6 million in the third quarter of fiscal year 2006. North American total revenues increased from \$59.7 million in the first nine months of fiscal year 2005 to \$71.5 million in the first nine months of fiscal

[Table of Contents](#)

year 2006. Revenues from international regions increased by \$4.4 million or approximately 25% from \$17.5 million for the first nine months of fiscal year 2005 to approximately \$21.9 million for the first nine months of fiscal year 2006. During the third quarter of fiscal year 2006, we derived 24% of our total revenues from sales outside of North America versus 22% in the same period last year. For the first nine months of fiscal years 2006 and 2005, we derived 23% of our total revenues from sales outside of North America.

Excluding results from performancesoft, North American total revenues increased from \$20.8 million in the third quarter of fiscal year 2005 to \$21.9 million in the third quarter of fiscal year 2006 and revenues from international regions also increased from \$6.0 million in the third quarter of fiscal year 2005 to \$6.8 million in the third quarter of fiscal year 2006. If performancesoft results are excluded, North American total revenues increased from \$59.7 million in the first nine months of fiscal year 2005 to \$65.7 million in first nine months of fiscal year 2006. Revenues from international regions also increased from \$17.5 million in the first nine months of fiscal year 2005 to \$19.5 million in the first nine months of fiscal year 2006 if performancesoft results are excluded.

Three trends continue to have a significant impact on results of our operations. We currently believe that corporate IT budgets will grow only modestly in the remainder of fiscal year 2006. Second, we continue to witness corporations consolidating their business intelligence, Enterprise Reporting software and Performance Management application purchases into fewer suppliers. Corporations were reluctant to buy software from new vendors. Finally, we continue to experience vigorous competition in the Enterprise Reporting market. Several of our competitors have released products that are marketed to be directly competitive with our Enterprise Reporting Application Platform. The existence of these competitive products required additional sales and marketing efforts to differentiate our products, which resulted in extended sales cycles. We believe that competition in the enterprise reporting market will continue to be vigorous in the near future.

During 2004, we announced four strategic initiatives to help improve the sale of our software products in the future. These initiatives are as follows:

- **Selling to IT Management**—We are re-focusing our sales efforts on selling our products to IT managers who we believe generally recognize the technical advantages of our products. We hope this initiative will result in increased license revenue in the short term.
- **Solution Selling to Line-of-Business Management**—We are creating software solutions to market to line-of-business managers. These solutions are in the areas of financial management and customer self service reporting. We hope this initiative will result in increased license revenue over the medium-to-long term.
- **Investing in the Business Intelligence Reporting Tool (“BIRT”)**—We are continuing to make a significant investment in creating a new open source code reporting tool, known as BIRT. We hope that BIRT will eventually become widely adopted by Java developers and will create demand for our other commercially available products. The BIRT project is a long-term initiative.
- **Selling to Global 9000 Corporations in the Financial Services Sector**—We are continuing to focus on selling our products to Global 9000 financial services companies in an effort to increase our substantive market share in this sector.

During 2005 and the first nine months of fiscal 2006, we continued to pursue these initiatives started in 2004 and we will continue to do so for the remainder of 2006. We have added the following strategic initiative resulting from our acquisition of performancesoft:

Delivering a highly differentiated Performance Management offering—we intend to combine performancesoft’s leading Performance Management applications and Actuate’s Enterprise Reporting Application Platform to provide capabilities for distributing accountability throughout the enterprise. We hope this initiative will result in increased license revenue in the short-to-medium term.

[Table of Contents](#)

We have a limited ability to forecast future revenues and expenses, thus the prediction of future operating results is difficult. In addition, historical growth rates in our revenues and earnings should not be considered indicative of future revenue or earnings growth rates or operating results. There can be no assurance that any of our business strategies will be successful or that we will be able to achieve and maintain profitability on a quarterly or annual basis. It is likely that in some future quarter our operating results will be below the expectations of public market analysts and investors, and in such event the price of our common stock could decline.

Actuate was incorporated in November 1993 in the State of California and reincorporated in the State of Delaware in July 1998. Actuate's principal executive offices are located at 701 Gateway Boulevard, South San Francisco, California. Actuate's telephone number is 650-837-2000. Actuate maintains a Web site at www.actuate.com.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Our critical accounting policies are described under Item 7 to the annual consolidated financial statements as of and for the year ended December 31, 2005, filed on Form 10-K with the SEC on March 13, 2006. We have added an accounting policy for stock-based compensation in fiscal year 2006 due to the adoption of SFAS 123(R). This new accounting policy is described below. Other than the addition of this new policy, our critical accounting policies have not changed since December 31, 2005.

Valuation of Stock-Based Compensation. Effective January 1, 2006, we adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123(R), Share-Based Payment ("SFAS 123(R)"). SFAS 123(R) establishes standards for accounting for transactions in which an entity exchanges its equity instruments, such as stock options, for goods or services, such as the services of the entity's employees. SFAS 123(R) also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. SFAS 123(R) eliminates the ability to account for stock-based compensation transactions using the intrinsic value method under APB 25 and generally requires instead that such transactions be accounted for using a fair-value based method. Accordingly, we measure stock-based compensation cost at the grant date, based on the fair value of the award, and recognize the expense over the employee's requisite service period using the modified prospective method. The measurement of stock-based compensation cost is based on several criteria including, but not limited to, the valuation model used and associated input factors such as expected term of the award, stock price volatility, dividend rate, risk free interest rate, and award forfeiture rate. The input factors to use in the valuation model are based on subjective future expectations combined with management judgment. If there is a difference between the assumptions used in determining stock-based compensation cost and the actual factors which become known over time, we may change the input factors used in determining stock-based compensation costs. These changes may materially impact our results of operations in the period such change are made.

Results of Operations

The following table sets forth certain consolidated statement of operations data as a percentage of total revenues for the periods indicated.

	Three Months Ended		Nine months Ended	
	September 30, 2006	2005	September 30, 2006	2005
Revenues:				
License fees	36%	33%	35%	34%
Services	64	67	65	66
Total revenues	100	100	100	100
Costs and expenses:				
Cost of license fees	1	2	2	2
Cost of services	21	21	23	22
Sales and marketing	37	35	38	34
Research and development	16	15	17	16
General and administrative	12	10	13	13
Amortization of other purchased intangibles	1	—	—	1
In-process research and development	—	—	1	—
Restructuring charges	—	—	—	1
Total costs and expenses	88	83	94	89
Income from operations	12	17	6	11
Interest and other income, net	2	1	1	1
Income before income taxes	14	18	7	12
Provision for income taxes	(5)	(4)	(3)	(2)
Net income	9%	14%	4%	10%

[Table of Contents](#)

Revenues

Our revenues are derived from license fees and services, which include software maintenance and support, consulting and training. Total revenues increased 19% from \$26.8 million for the quarter ended September 30, 2005 to \$31.9 million for the quarter ended September 30, 2006. A large portion of this increase was due to continued increase in new and repeat business from a number of Global 9000 customers (companies with annual revenues greater than \$1.0 billion) and further expansion of our product and services into financial and government sectors. As a result of these positive trends, we experienced improvements in our license, maintenance and support revenues for a combined increase of 19% or approximately \$5.1 million over the same period last year. Of this increase, approximately 12% or \$3.2 million was associated with our acquisition of performancesoft that was completed in January of fiscal year 2006.

For the nine months of fiscal year 2006, total revenues were \$93.4 million, a 21% or approximately \$16.2 million increase over the same period last year. This increase was seen across all revenue categories. Actuate's business, excluding performancesoft, experienced a 10% or approximately \$8.0 million increase over the same period last year, while performancesoft accounted for an increase of 11%, or approximately \$8.2 million.

Sales outside of North America were \$7.6 million or 24% of total revenues for the third quarter of fiscal year 2006, compared to \$6.0 million or 22% of total revenues for the third quarter of fiscal year 2005. For the nine months ended September 30, 2006, sales outside of North America were \$21.9 million, or 23% of total revenues as compared to \$17.5 million, or 23% of total revenues as compared to the nine months ended September 30, 2005. No single customer accounted for more than 10% of our revenues for any of the periods presented.

	Three Months Ended				Nine months Ended			
	(In thousands)				(In thousands)			
	September 30,		Variance	Variance	September 30,		Variance	Variance
	2006	2005	\$'s	%	2006	2005	\$'s	%
-45								
Revenues								
License fees	\$ 11,585	\$ 8,894	\$ 2,691	30%	\$ 32,756	\$ 26,647	\$ 6,109	23%
Services	20,344	17,951	2,393	13%	60,689	50,593	10,096	20%
Total Revenues	\$ 31,929	\$ 26,845	\$ 5,084	19%	\$ 93,445	\$ 77,240	\$ 16,205	21%
% of Revenue								
License fees	36%	33%			35%	34%		
Services	64%	67%			65%	66%		
Total Revenues	100%	100%			100%	100%		

Table of Contents

License fees. The increase in license revenues for the third quarter of fiscal year 2006 as compared to the same period in the prior year was primarily due to our acquisition of performancesoft, which added approximately \$1.7 million to license revenue in the third quarter of fiscal year 2006. Additionally, in the third quarter of fiscal year 2006 we recorded an order for \$1.3 million in license revenue resulting from the conclusion of a license royalty compliance issue, which included royalty revenues accrued since the fourth quarter of fiscal year 2005. The increase in license revenues for the first nine months of fiscal year 2006 was primarily due to our acquisition of performancesoft, which represented approximately \$4.5 million of revenue and an increase in the total number of recognized high-dollar product license transactions, such as the royalty compliance issue described above. No single customer accounted for more than 10% of our revenues for any of the periods presented.

The regions that realized the most significant license revenue growth were the North America and the EMEA regions, which accounted for a \$2.3 million and \$500,000 increase in license revenues, respectively, over the third quarter of fiscal year 2005. These increases were offset by Asia Pacific which experienced a 10% or approximately \$100,000 decrease in license revenue over the third quarter of fiscal year 2005. By region, North America accounted for approximately 77% of the total license revenue while the Europe and Asia Pacific regions accounted for 17% and 6% of the total license revenues, respectively. For the same period last year, North America accounted for approximately 75% of the total license revenue while the Europe and Asia Pacific regions accounted for 16% and 9% of the total license revenues, respectively. As a percentage of total revenues, license fee revenues increased from 33% in the third quarter of fiscal year 2005 to 36% in the third quarter of fiscal year 2006.

Excluding the acquisition of performancesoft, the region that realized the most significant license revenue growth was the North America region, which accounted for an 15% or approximately \$1.0 million increase in license revenues over the third quarter of fiscal year 2005, while EMEA region, excluding performancesoft, experienced a modest growth of 5% or approximately \$100,000. These increases were offset by the Asia Pacific region which experienced a 10% or approximately \$100,000 decrease in license revenues (excluding performancesoft) over the third quarter of fiscal year 2005. Excluding performancesoft, the North America region accounted for approximately 78% of the total license revenue while the Europe and Asia Pacific regions accounted for 15% and 7% of the total license revenues, respectively. Excluding performancesoft, and for the same period last year, North America accounted for approximately 75% of the total license revenue while the Europe and Asia Pacific regions accounted for 16% and 9% of the total license revenues, respectively.

Services. The increase in services revenues was primarily driven by the growth in our maintenance and support revenues, which increased in the third quarter of fiscal year 2006 by 17% or \$2.3 million over the same quarter last year. The primary contributor to the growth came from continued expansion in our installed base of customers under maintenance plans, as well as a continued implementation of an aggressive renewal campaign by our maintenance renewal group. Maintenance and support revenues related to performancesoft accounted for approximately \$1.0 million of the total increase. We also experienced modest growth in our professional services and training revenues, which increased by approximately 2% or \$100,000 over the three months ended September 30, 2005. This was primarily attributed to revenues from performancesoft which showed an increase in services revenues of approximately \$450,000. Excluding the acquisition of performancesoft, professional services revenues decreased by 9%. This decrease was primarily attributed to two significant engagements during the third quarter of fiscal year 2005 that resulted in higher consulting revenues over the third quarter of fiscal year 2006. Service margins decreased from 68% in the third quarter of fiscal year 2005 to 67% in the third quarter of fiscal year 2006. By region, North America continued to account for approximately 76% of the total services revenue while the Europe and Asia Pacific regions accounted for 21% and 3% of the total services revenues, respectively. For the same period last year, North America accounted for approximately 79% of the total services revenue while the Europe and Asia Pacific regions accounted for 17% and 4% of the total services revenues, respectively.

The growth in services revenues for the nine months ended September 30, 2006 was primarily attributed to the increase in our maintenance and support revenues of approximately 20% or \$7.8 million, driven by a continued growth in our installed base of customers under maintenance plans and our continued implementation of an aggressive renewal campaign by our maintenance renewal group. Of the total increase in maintenance and support revenues, \$2.4 million was attributed to our acquisition of performancesoft in January of 2006. Consulting services revenues also increased by 19% or \$2.3 million during the first nine months of fiscal year 2006. This increase was primarily due to the acquisition of performancesoft which accounted for \$1.3 million of the growth while the remaining increase of approximately \$1.0 million was attributed to our business excluding performancesoft.

[Table of Contents](#)

Operating Expenses

Cost of license fees

	Three Months Ended				Nine months Ended			
	(In thousands)				(In thousands)			
	September 30,		Variance	Variance	September 30,		Variance	Variance
	2006	2005	\$'s	%	2006	2005	\$'s	%
-45								
Cost of license fees	\$ 465	\$ 489	\$ (24)	(5)%	\$ 1,431	\$ 1,804	\$ (373)	(21)%
% of license revenue	4%	5%			4%	7%		

Cost of license fees consists primarily of product packaging, documentation, production costs and the amortization of purchased technology. The decrease in costs of license fees in absolute dollars for the third quarter of fiscal year 2006, compared to the corresponding period in the prior year, was not significant. For the nine months ended September 30, 2006 the decrease in cost of license fees compared to the corresponding period in the prior year, was primarily due to reduced compensation, printing and production related costs as well as amortization of the purchased technologies associated with the acquisition of Tidestone and Nimble which had been fully amortized in fiscal year 2006 which more than offset the increase in amortization of purchased intangibles derived from the performance software acquisition. We expect our cost of license fees, as a percentage of revenues from license fees, to remain between 4% and 7% of revenues from license fees for the remainder of fiscal year 2006.

Cost of services

	Three Months Ended				Nine months Ended			
	(In thousands)				(In thousands)			
	September 30,		Variance	Variance	September 30,		Variance	Variance
	2006	2005	\$'s	%	2006	2005	\$'s	%
-45								
Cost of services	\$ 6,788	\$ 5,702	\$ 1,086	19%	\$ 21,387	\$ 17,271	\$ 4,116	24%
% of services revenue	33%	32%			35%	34%		

Cost of services consists primarily of personnel and related costs, stock-based compensation, facilities costs incurred in providing software maintenance and support, training and consulting services, as well as third-party costs incurred in providing training and consulting services. The increase in cost of services for the third quarter of fiscal year 2006, compared to the corresponding period in the prior year, was primarily due to a (i) 32% increase to our headcount driven primarily by the acquisition of performance software in January of 2006, and (ii) the expensing of stock options related to the adoption of SFAS 123R as of January 1, 2006 (see Note 1 to the condensed consolidated financial statements) which increased cost of services expense by approximately \$200,000 for the three months ended September 30, 2006.

For the nine months ended September 30, 2006 the increase in cost of services was primarily due to (i) a 32% increase to our headcount driven primarily by the acquisition of performance software in January 2006, (ii) an increase in third party consulting fees of approximately \$1.5 million driven by the use of consultants to compensate for unusually high employee consultant turnover in North America during fiscal year 2006, as well as heavy use of consultants to support high e.Service revenue growth in Europe during fiscal year 2006, and (iii) the expensing of stock options related to the adoption of SFAS 123R as of January 1, 2006 (see Note 1 to the condensed consolidated financial statements) which increased cost of services expense by approximately \$600,000 for the nine months ended September 30, 2006. These increases were offset by decreases in employee compensation and related costs, excluding performance software of approximately \$200,000. We currently expect our cost of services expenses as a percentage of total services revenues to be in the range of 33% to 38% of total services revenues for the remainder of fiscal year 2006.

Table of Contents

Sales and marketing

	Three Months Ended				Nine months Ended			
	(In thousands)				(In thousands)			
	September 30,		Variance	Variance	September 30,		Variance	Variance
	2006	2005	\$'s	%	2006	2005		
-45								
Sales and marketing	\$ 11,879	\$ 9,411	\$ 2,468	26%	\$ 35,586	\$ 26,564	\$ 9,022	34%
% of total revenue	37%	35%			38%	34%		

Sales and marketing expenses consist primarily of salaries, commissions, stock-based compensation and bonuses earned by sales and marketing personnel, promotional expenses, travel, entertainment and facilities costs. The increase in sales and marketing expenses in both absolute dollars and as a percentage of total revenues for the third quarter of fiscal year 2006 was primarily due to (i) a 22% increase to our headcount driven primarily by the acquisition of performancesoft in January of 2006, which increased sales and marketing expenses by approximately \$2.0 million, and (ii) the expensing of stock options related to the adoption of SFAS 123R as of January 1, 2006 (see Note 1 to the condensed consolidated financial statements) which increased sales and marketing expenses by approximately \$600,000 for the three months ended September 30, 2006. These increases were offset by decreases of approximately \$200,000 in other marketing and promotional related costs.

For the nine months ended September 30, 2006 the increase in sales and marketing expenses was primarily due to an increase of \$5.5 million in compensation, travel and other employee related expenses. This increase was primarily the result of a 22% increase to our sales and marketing related headcount, which was driven mainly by the acquisition of performancesoft. The increase in overall sales and marketing expenses was also a result of higher commissions driven by increased sales in fiscal year 2006, as well as merit increases which were approved in the first quarter of the year. In addition to the increase in employee related expenses, total sales and marketing expenses also increased as a result of the expensing of stock options related to the adoption of SFAS 123R as of January 1, 2006 (see Note 1 to the condensed consolidated financial statements) which increased sales and marketing expenses by approximately \$1.7 million for the nine months ended September 30, 2006. We currently expect our sales and marketing expenses as a percentage of total revenues to be in the range of 37% to 40% of total revenues for the remainder of fiscal year 2006.

Research and development

	Three Months Ended				Nine months Ended			
	(In thousands)				(In thousands)			
	September 30,		Variance	Variance	September 30,		Variance	Variance
	2006	2005	\$'s	%	2006	2005		
-45								
Research and development	\$ 5,166	\$ 4,011	\$ 1,155	29%	\$ 15,776	\$ 12,370	\$ 3,406	28%
% of total revenue	16%	15%			17%	16%		

Research and development costs consist primarily of personnel and related costs associated with the development of new products, stock-based compensation costs, enhancement of existing products, and quality assurance and testing. The increase in research and development expenses in the third quarter of fiscal year 2006 was primarily attributed to a 16% increase to our headcount driven primarily by the acquisition of performancesoft in January of 2006, which increased research and development expenses by approximately \$700,000, and the expensing of stock options related to the adoption of SFAS 123R as of January 1, 2006 (see Note 1 to the condensed consolidated financial statements) which increased research and development costs by approximately \$300,000 for the three months ended September 30, 2006.

For the nine months ended September 30, 2006 the increase in research and development expenses was primarily due to (i) an increase of \$1.7 million in compensation, travel and other employee related expenses. This increase was primarily the result of a 16% increase to our research and development related headcount, which was primarily driven by the acquisition of performancesoft in January of 2006. The increase in overall research and development expenses was also a result of higher expenses related to professional services in support of the release of version 9 of our products in the third quarter of this year, as well as merit increases which were approved in the first quarter of the year. In addition to these increases, total research and development expenses further increased as a result of the expensing of stock options related to the adoption of SFAS 123R as of January 1, 2006 (see Note 1 to the condensed consolidated financial statements) which increased research and development costs by approximately \$900,000 for the nine months ended September 30, 2006. We believe that continued investments in technology and product development are essential for us to remain competitive in the markets we serve, and expect our research and development expenses as a percentage of total revenues to be in the range of 16% to 19% of total revenues for the remainder of fiscal year 2006.

Table of Contents

General and administrative

	Three Months Ended				Nine months Ended			
	(In thousands)				(In thousands)			
	September 30,		Variance		September 30,		Variance	
	2006	2005	\$'s	%	2006	2005	\$'s	%
-45								
General and administrative	\$ 3,758	\$ 2,622	\$ 1,136	43%	\$ 12,021	\$ 9,933	\$ 2,088	21%
% of total revenue	12%	10%			13%	13%		

General and administrative expenses consist primarily of personnel costs, stock-based compensation costs and related costs for finance, human resources, information systems and general management, as well as legal, bad debt and accounting expenses. The increase in general and administrative expenses in both absolute dollars and as a percentage of total revenues for the third quarter of fiscal year 2006 was primarily due to (i) the expensing of stock options related to the adoption of SFAS 123R as of January 1, 2006 (see Note 1 to the condensed consolidated financial statements) which increased general and administrative expenses by approximately \$600,000 for the three months ended September 30, 2006, (ii) a \$500,000 increase in employee compensation and related costs, which was driven by a 15% increase in headcount primarily related to the acquisition of performancesoft in January of 2006. The three months ended September 30, 2006 and 2005 also reflected a reduction in the bad debt reserve of \$220,000 and \$240,000, respectively.

For the nine months ended September 30, 2006 the increase in general and administrative expenses was primarily due to (i) the expensing of stock options related to the adoption of SFAS 123R as of January 1, 2006 (see Note 1 to the condensed consolidated financial statements) which increased general and administrative expenses by approximately \$1.6 million for the nine months ended September 30, 2006, and (ii) a \$1.4 million increase in employee related costs which was driven by a 15% increase in our headcount primarily related to the acquisition of performancesoft in January of 2006. These increased expenses were offset by decreases in (i) accounting and other professional fees of approximately \$1.2 million due to lower Section 404 compliance audit fees and legal fees associated with the MicroStrategy case, and (ii) a decrease of approximately \$200,000 in total bad debt expense. We expect our general and administrative expenses to be in the range of 12% to 15% of total revenues for the remainder of the fiscal year 2006.

Amortization of other intangibles

	Three Months Ended				Nine months Ended			
	(In thousands)				(In thousands)			
	September 30,		Variance		September 30,		Variance	
	2006	2005	\$'s	%	2006	2005	\$'s	%
-45								
Amortization of other intangibles	\$ 237	\$ 17	\$ 220	1,294%	\$ 711	\$ 487	\$ 224	46%
% of total revenue	1%	—			—	1%		

The increase in amortization of other purchased intangibles in both absolute dollars and as a percentage of total revenues for the third quarter of fiscal year 2006 was due to increases in amortization costs of \$237,000 related to our acquisition of performancesoft in January of fiscal year 2006. This increase was offset by the fact that we fully amortized the other intangibles associated with our acquisitions of Tidestone and Nimble Technology by the second and third quarter of fiscal year 2005, respectively. For the first nine months of fiscal year 2006, amortization of other intangibles increased by

Table of Contents

\$711,000 primarily due to the amortization of intangibles recorded in connection with our acquisition of performancesoft in January of fiscal year 2006, offset by full amortization of other intangibles associated with our acquisitions of Tidestone and Nimble Technology.

Purchased in-process research and development

For the first nine months of fiscal year 2006 and in connection with the acquisition of performancesoft, we recorded a charge to operations of \$900,000 for purchased in-process research and development. This charge was recorded during the first quarter of fiscal year 2006 and was expensed because it had not reached technological feasibility and had no alternative future uses. The value of the purchased in-process research and development was computed using the excess earnings approach analysis, which is based on the theory that all assets must contribute to the profitability of an enterprise. We determined the valuation of the purchased in-process research and development with the assistance of an independent third party.

Interest and other income, net

	Three Months Ended				Nine months Ended			
	(In thousands)				(In thousands)			
	September 30,		Variance	Variance	September 30,		Variance	Variance
	2006	2005	\$'s		2006	2005	\$'s	
-45								
Interest and other income, net	\$ 636	\$ 376	\$ 260	69%	\$ 1,314	\$ 909	\$ 405	45%
% of total revenue	2%	1%			1%	1%		

Interest and other income, net, is comprised primarily of interest income earned by the Company on cash and short-term investments as well as the effects of foreign currency fluctuation. Interest income increased by approximately \$140,000 during the third quarter of fiscal year 2006 compared to the same period last year due primarily to a higher weighted average interest rate on our investments. We also experienced an increase of approximately \$100,000 in other income due to an increase in the expected refund of investment tax credits related to our research and development operations in Canada.

For the nine months ended September 30, 2006, the 45% increase was primarily due to a higher weighted average interest rate on our investments which resulted in higher interest income in fiscal year 2006, an increase in the expected refund of investment tax credits related to our research and development operations in Canada, as well as the fact that we incurred a \$300,000 asset impairment charge in fiscal year 2005. These changes were partially offset by increased foreign exchange losses in fiscal year 2006.

Provision for income taxes

	Three Months Ended				Nine months Ended			
	(In thousands)				(In thousands)			
	September 30,		Variance	Variance	September 30,		Variance	Variance
	2006	2005	\$'s		2006	2005	\$'s	
-45								
Provision for income taxes	\$ 1,745	\$ 1,225	\$ 520	42%	\$ 3,303	\$ 1,507	\$ 1,796	119%
% of total revenue	(5)%	(4)%			(3)%	(2)%		

We recorded an income tax provision of \$1.7 million in the three months ended September 30, 2006 as compared to an income tax provision of \$1.2 million in the three months ended September 30, 2005. For the nine months ended September 30, 2006, we recorded an income tax provision of \$3.3 million, as compared to an income tax provision of \$1.5 million for the same period of fiscal year 2005. The increase in the income tax provision for 2006 as compared to 2005 is due to higher projected domestic pre-tax income for 2006, which allows for the usage of NOL's and R & D tax credits, a higher effective tax as a result of adopting SFAS 123R and the write off of in-process R & D of \$900,000 treated as a discrete event. The book expenses as a result of SFAS 123R lowers our pre-tax net income, however, the amounts are not deductible for tax purposes, which produces a higher effective tax rate.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized on a jurisdiction by jurisdiction basis. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the historical income, projected future income, the expected timing of the reversals of existing

[Table of Contents](#)

temporary differences and the implementation of tax-planning strategies in making this assessment. Based upon the level of historical tax losses, management believes it is more likely than not that the Company will not realize a majority of the benefits of these deductible differences. Therefore, a valuation allowance has been established to offset the deferred tax assets where these benefits may not be realized.

The Company, however, may determine it will be able to realize all or a portion of its deferred tax assets in the U.S. in the foreseeable future. Upon such determination a reduction of valuation allowance related to its deferred tax assets would cause a material increase to net earnings in the period in which such determination is made. Significant management judgment is required in determining the period in which the reversal of a valuation allowance should occur. The Company considers all available evidence, both positive and negative, in making this determination, including historical income, projected future income, the expected timing of the reversals of existing temporary differences and the implementation of tax-planning strategies.

The Company's ability to utilize the net operating losses and tax credit carry-forwards in the future may be subject to an annual limitation in the event of past or future ownership changes as defined in Section 382 of the Internal Revenue Code and similar state tax laws. The annual limitation may result in the expiration of net operating losses and tax credits before utilization.

Liquidity and Capital Resources

Our sources of cash, cash equivalents and short-term investments are funds generated from our business operations and funds that may be drawn down under our credit facility.

At September 30, 2006, we had cash, cash equivalents and short-term investments of \$47.5 million, a decrease of approximately \$6.9 million from \$54.4 million at December 31, 2005. This decrease was largely due to our cash outlay for the acquisition of performancesoft in the first quarter of fiscal year 2006. We also had \$32.2 million in net working capital at September 30, 2006, representing a decrease of approximately \$6.7 million from \$38.9 million at December 31, 2005. The decrease in working capital was primarily due to our acquisition of performancesoft in the first quarter of fiscal year 2006 which resulted in a reduction to cash and cash equivalents.

Net cash provided by operating activities during the nine months ended September 30, 2006 was \$9.4 million, resulting from a net income of \$3.6 million, adjusted for non-cash charges, including \$4.8 million in stock-based compensation, \$2.7 million of depreciation and amortization, purchased in-process research and development of \$900,000 related to our acquisition of performancesoft, and an increase in our deferred revenues of \$2.4 million primarily due to increased sales. These increases were offset by a decrease of approximately \$150,000 from accounts receivables due to higher days sales outstanding, which increased from 70 days at September 30, 2005 to 81 days at September 30, 2006 as well as decreases totaling approximately \$5.0 million in accounts payable, accrued compensation and other associated liabilities.

Our primary source of operating cash flows is the collection of accounts receivable from our customers, including maintenance, which is typically billed annually in advance. Our operating cash flows are also impacted by the timing of payments to our vendors for accounts payable. We generally pay our vendors and service providers in accordance with the invoice terms and conditions. The timing of cash payments in future periods will be impacted by the terms of accounts payable arrangements and the timing of our cash inflows.

Cash used in investing activities was \$7.5 million for the nine months ended September 30, 2006 compared to approximately \$1.1 million provided in the same period in fiscal 2005. The primary driver for this decrease during the first nine months of fiscal year 2006 was the acquisition of performancesoft, which resulted in a net cash payment of approximately \$15.3 million. Due to this acquisition, we liquidated our investments by a total of approximately \$13.2 million to accommodate the funding of this transaction. In addition, during February 2006, a minority shareholder of Actuate Japan notified us that it wished to exercise its rights to put its equity interest in Actuate Japan and as a result we paid approximately \$354,000 for this minority interest during the first quarter of 2006.

Cash provided by financing activities was approximately \$470,000 for the nine months ended September 30, 2006 compared to \$4.5 million used for the same period in fiscal year 2005. The increase in cash provided was primarily the result of the tax benefits realized from exercise of stock options and higher proceeds from the issuance of common stock during the first nine months of fiscal year 2006, offset by lower level of stock repurchases.

We believe that our current cash balances and cash generated from operations will be sufficient to meet our working capital and capital expenditures requirements for at least the next twelve months. Thereafter, if cash generated from operations is insufficient to satisfy our liquidity requirements, we may find it necessary to sell additional equity, draw down under our existing credit facility or obtain additional credit facilities. The sale of additional equity could result in additional

[Table of Contents](#)

dilution to our current stockholders. A portion of our cash may be used to acquire or invest in complementary businesses, including the acquisition of the minority interest in our 88% owned subsidiary in Japan, or complementary products or to obtain the right to use complementary technologies.

Contractual Obligations and Commercial Commitments.

The following table summarizes our contractual obligations as of September 30, 2006 (in thousands):

	<u>Total</u>	<u>Less than 1 year</u>	<u>1 – 3 years</u>	<u>3 – 5 years</u>	<u>Thereafter</u>
Obligations:					
Operating lease (1)	\$ 19,207	\$ 5,654	\$ 7,478	\$ 5,931	\$ 144
Purchase obligations (2)	2,816	2,816	—	—	—
Total	<u>\$ 22,023</u>	<u>\$ 8,470</u>	<u>\$ 7,478</u>	<u>\$ 5,931</u>	<u>\$ 144</u>

- (1) Our future contractual obligations include minimum lease payments under operating leases at September 30, 2006, net of contractual sublease proceeds. Of the remaining net future minimum lease payments, approximately \$10.9 million is included in restructuring liabilities on the Company's consolidated balance sheet as of September 30, 2006.
- (2) Purchase obligations represent an estimate of all open purchase orders and contractual obligations in the ordinary course of business for which we have not received the goods or services as of September 30, 2006. Although open purchase orders are considered enforceable and legally binding, the terms generally allow us the option to cancel, reschedule and adjust our requirements based on our business needs prior to the delivery of goods or performance of services.

In connection with the office building leases in South San Francisco, California, we initially provided the landlord with letters of credit in the amount of \$3.9 million as a security deposit. We have provided a security interest in all of our assets as collateral for the letter of credit. These letters of credit have been reduced at pre-determined intervals. As of September 30, 2006 the amounts remaining under these letters of credit total approximately \$700,000.

[Table of Contents](#)

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk. Market risk represents the risk of loss that may impact our financial position due to adverse changes in financial market prices and rates. Our market risk exposure is primarily a result of credit risk, fluctuations in interest rates and foreign exchange rates.

Foreign Currency Exchange Risk. During the first nine months of fiscal years 2006 and 2005 we derived 23% and 23%, respectively, of our total revenues from sales outside of North America. We face exposure to market risk on these receivables with respect to fluctuations in the relative value of currencies. Our international revenues and expenses are denominated in foreign currencies, principally the Euro and the British Pound Sterling. The functional currency of each of our foreign subsidiaries is the local currency. We are also exposed to foreign exchange rate fluctuations as the financial results of foreign subsidiaries are translated into U.S. dollars in consolidation. As exchange rates vary, transaction gains and losses may vary from expectations and adversely impact overall expected profitability. Our realized losses due to foreign exchange rate fluctuations were approximately \$120,000 for the first nine months of fiscal 2006 compared to realized gains of approximately \$124,000 during the same period last year.

Interest Rate Risk. The primary objective of our investment activities is to preserve principal while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we invest in highly liquid and high quality debt securities. Due to the nature of our investments, we believe that there is no material risk exposure.

Credit Risk. Financial instruments that potentially subject us to concentrations of credit risk consist primarily of cash and cash equivalents, investments in marketable securities, trade accounts receivable. We have policies that limit investments in investment grade securities and the amount of credit exposure to any one issuer. We perform ongoing credit evaluations of our customers and maintain an allowance for potential credit losses. We do not require collateral or other security to support client receivables. Our credit risk is also mitigated because our customer base is diversified by geography and no single customer has accounted for more than 10% of our consolidated revenue on an annual basis. We generally do not use foreign exchange contracts to hedge the risk in receivables denominated in foreign currencies. We do not hold or issue derivative financial instruments for trading or speculative purposes.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report (the "Evaluation Date"), the Company carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")). Based on an evaluation under the supervision and with the participation of the Company's management, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) were effective as of September 30, 2006 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms and (ii) accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Controls

There were no changes in Actuate's internal control over financial reporting during the three months ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, Actuate's internal control over financial reporting.

In January 2006, the Company acquired all of the outstanding shares of capital stock of performancesoft, Inc., a privately-held entity headquartered in Toronto, Canada. Subsequent to the acquisition, the Company has instituted changes to performancesoft internal control over financial reporting and we are currently aligning performancesoft's internal controls over financial reporting with the Company's controls over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

The Company is engaged in certain legal actions arising in the ordinary course of business, including international employment litigation arising out of restructuring activities. Although there can be no assurance as to the outcome of such litigation, the Company believes that it has adequate legal defenses and that the ultimate outcome of any of these actions will not have a material effect on the Company's financial position or results of operations.

[Table of Contents](#)

Item 1A. Risk Factors

Investors should carefully consider the following risk factors and warnings before making an investment decision. The risks described below are not the only ones facing Actuate. Additional risks that we do not yet know of or that we currently think are immaterial may also materially impair our business operations. If any of the following risks, currently unknown risks, or currently known risks that are mistakenly believed to be immaterial, actually occur, our business, operating results or financial condition could be materially harmed. In such case, the trading price of our common stock could decline and you may lose all or part of your investment. Investors should also refer to the other information set forth in this Quarterly Report on Form 10-Q, including the financial statements and the notes thereto.

THE COMPANY'S OPERATING RESULTS MAY BE VOLATILE AND DIFFICULT TO PREDICT. IF IT FAILS TO MEET ITS ESTIMATES OF QUARTERLY AND ANNUAL OPERATING RESULTS OR IT FAILS TO MEET THE EXPECTATIONS OF PUBLIC MARKET ANALYSTS AND INVESTORS, THE MARKET PRICE OF ITS STOCK MAY DECREASE SIGNIFICANTLY.

The susceptibility of the Company's operating results to significant fluctuations makes any prediction, including the Company's estimates of future operating results, difficult. In addition, the Company believes that period-to-period comparisons of its operating results are not necessarily meaningful and you should not rely on them as indications of the Company's future performance. The Company's operating results have in the past varied, and may in the future vary significantly due to factors such as the following:

- Demand for its products;
- The size and timing of significant orders for its products;
- A slowdown or a decrease in spending on information technology by its current and/or prospective customers;
- Competition from products that are directly competitive with its products;
- Lost revenue from introduction or market acceptance of open source products that are directly competitive with its products;
- The management, performance and expansion of its international operations;
- Foreign currency exchange rate fluctuations;
- Customers' desire to consolidate their purchases of enterprise reporting and business intelligence software to one or a very small number of vendors from which a customer has already purchased software;
- General domestic and international economic and political conditions, including war, terrorism, and the threat of war or terrorism;
- Sales cycles and sales performance of its indirect channel partners;
- Changes in the way it and its competitors price their respective products and services, including maintenance and transfer fees;
- Continued successful relationships and the establishment of new relationships with OEMs;
- Changes in its level of operating expenses and its ability to control costs;
- The outcome or publicity surrounding any pending or threatened lawsuits;
- Ability to make new products and product enhancements commercially available in a timely manner;
- Ability to effectively launch new or enhanced products, including the timely education of the Company's sales, marketing and consulting personnel with respect to such new or enhanced products.;
- Customers delaying purchasing decisions in anticipation of new products or product enhancements;
- Budgeting cycles of its customers;
- Failure to successfully manage its acquisitions;
- Defects in its products and other product quality problems;
- Failure to successfully meet hiring needs including for qualified professional services employees and unexpected personnel changes;
- Changes in the market segments and types of customers at which it focuses its sales and marketing efforts;

Table of Contents

- Changes in perpetual licensing models to term- or subscription-based models with respect to which license revenue is not fully recognizable at the time of initial sale; and
- Changes in service models with respect to which consulting services are performed on a fixed-fee, rather than variable fee, basis.

Because the Company's software products are typically shipped shortly after orders are received, total revenues in any quarter are substantially dependent on orders booked and shipped throughout that quarter. Furthermore, several factors may require the Company, in accordance with accounting principles generally accepted in the United States, to defer recognition of license fee revenue for a significant period of time after entering into a license agreement, including:

- Whether the license agreement includes both software products that are then currently available and software products or other enhancements that are still under development;
- Whether the license agreement relates entirely or partly to software products that are currently not available;
- Whether the license agreement requires the performance of services that may preclude revenue recognition until successful completion of such services;
- Whether the license agreement includes acceptance criteria that may preclude revenue recognition prior to customer acceptance; and
- Whether the license agreement includes undelivered elements (including limited terms or durations) that may preclude revenue recognition prior to customer acceptance.

In addition, the Company may in the future experience fluctuations in its gross and operating margins due to changes in the mix of its domestic and international revenues, changes in the mix of its direct sales and indirect sales and changes in the mix of license revenues and service revenues, as well as changes in the mix among the indirect channels through which its products are offered.

A significant portion of the Company's total revenues in any given quarter is derived from existing customers. The Company's ability to achieve future revenue growth, if any, will be substantially dependent upon its ability to increase revenues from license fees and services from existing customers, to expand its customer base and to increase the average size of its orders. To the extent that such increases do not occur in a timely manner, the Company's business, operating results and financial condition would be harmed.

The Company's expense levels and any plans for expansion, are based in significant part on its expectations of future revenues and are relatively fixed in the short-term. If revenues fall below its expectations and it is unable to reduce its spending in response quickly, the Company's business, operating results, and financial condition are likely to be harmed.

The Company has implemented changes to its license pricing structure. If these changes are not accepted by the Company's current customers or future customers, its business, operating results, and financial condition could be harmed.

Based upon all of the factors described above, the Company has a limited ability to forecast the amount and mix of future revenues and expenses and it is likely that at some time, the Company's operating results will be below its estimates or the expectations of public market analysts and investors. In the event that operating results are below its estimates or other expectations, the price of the Company's common stock is likely to decline.

THE COMPANY HAS MADE, AND MAY IN THE FUTURE MAKE, ACQUISITIONS, WHICH INVOLVE NUMEROUS RISKS.

The Company's business is highly competitive, and as such, its growth is dependent upon market growth and its ability to enhance its existing products, introduce new products on a timely basis and expand its distribution channels and professional services organization. One of the ways the Company has addressed and will continue to address these issues is through acquisitions of other companies. On January 5, 2006, the Company purchased all of the outstanding capital stock of performancesoft, Inc., a privately held company located in Toronto, Canada ("performancesoft").

Specifically, the acquisition of performancesoft involves numerous risks, including the following:

- The Company's ability to maintain or achieve performancesoft revenue growth or to anticipate a decline in performancesoft revenue from any of its products or services;
- The Company's ability to develop and introduce performancesoft products (including the product known as Track which was released in the Company's third quarter) and enhancements that respond to its customer requirements and rapid technological change;

Table of Contents

- The Company's ability to maintain or select and implement appropriate business models and strategies for performancesoft;
- The risks inherent in international operations, such as currency exchange rate fluctuations and economic and political conditions in Canada;
- The performancesoft transaction was completed without the benefit of audited financial statements from performancesoft;
- performancesoft must transition its sales process to take into account revenue recognition requirements under US GAAP and slowness in doing so could impact the Company's revenue and earnings and result in increased deferred revenue;
- The performancesoft stock purchase agreement includes large escrow (\$2.65 million, of which \$1.0 million was paid out subsequent to September 30, 2006) and earnout or contingent consideration (up to \$13.5 million) provisions that could be the subject of disputes between the Company and certain former performancesoft shareholders; and
- The performancesoft stock purchase agreement includes a covenant whereby the Company has agreed to keep the performancesoft subsidiary separate through fiscal 2006.

Generally, acquisitions (including that of performancesoft) involve numerous risks, including the following:

- The benefits of the acquisition not materializing as planned or not materializing within the time periods or to the extent anticipated;
- The Company's ability to manage acquired entities' people and processes that are headquartered in separate geographical locations from the Company's headquarters;
- The possibility that the Company will pay more than the value it derives from the acquisition;
- Difficulties in integration of the operations, technologies, and products of the acquired companies;
- The assumption of certain known and unknown liabilities of the acquired companies;
- Difficulties in retaining key relationships with customers, partners and suppliers of the acquired company;
- The risk of diverting management's attention from normal daily operations of the business;
- The Company's ability to issue new releases of the acquired company's products on existing or other platforms;
- Negative impact to the Company's financial condition and results of operations and the potential write down of impaired goodwill and intangible assets resulting from combining the acquired company's financial condition and results of operations with its financial statements;
- Risks of entering markets in which the Company has no or limited direct prior experience; and
- The potential loss of key employees of the acquired company.

Mergers and acquisitions of high-technology companies are inherently risky, and the Company cannot be certain that any acquisition will be successful and will not materially harm the Company's business, operating results or financial condition.

INTELLECTUAL PROPERTY CLAIMS AGAINST THE COMPANY CAN BE COSTLY AND COULD RESULT IN THE LOSS OF SIGNIFICANT RIGHTS.

Third parties may claim that the Company's current or future products infringe their intellectual property rights. The Company has been subject to infringement claims in the past and it expects that companies in the Business Intelligence software market will increasingly be subject to infringement claims as the number of products and/or competitors in its industry segment grows and the functionality of products in different industry segments overlaps. Any such claims, with or without merit, could be time-consuming to defend, result in costly litigation and expenses, divert management's attention and resources, cause product shipment delays or require the Company to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to the Company or at all. A successful claim of product infringement against the Company and its failure or inability to license the infringed or similar technology could harm the Company's business, operating results and financial condition.

[Table of Contents](#)

IF THE COMPANY FAILS TO GROW REVENUE FROM INTERNATIONAL OPERATIONS AND EXPAND ITS INTERNATIONAL OPERATIONS ITS BUSINESS WOULD BE SERIOUSLY HARMED.

The Company's total revenues derived from sales outside North America were 23%, 23% and 22% for the first nine months of fiscal years 2006, 2005 and 2004, respectively. Its ability to achieve revenue growth in the future will depend in large part on its success in increasing revenues from international sales. The Company intends to continue to invest significant resources to expand its sales and support operations outside North America and to enter additional international markets. In order to expand international sales, the Company must establish additional foreign operations, expand its international channel management and support organizations, hire additional personnel, recruit additional international resellers and increase the productivity of existing international resellers. If it is not successful in expanding international operations in a timely and cost-effective manner, the Company's business, operating results and financial condition could be harmed.

IF THE COMPANY DOES NOT SUCCESSFULLY EXPAND ITS DISTRIBUTION CHANNELS AND DEVELOP AND MAINTAIN RELATIONSHIPS WITH OEMs, ITS BUSINESS WOULD BE SERIOUSLY HARMED.

To date, the Company has sold its products principally through our direct sales force, as well as through indirect sales channels, such as its OEMs, resellers and systems integrators. The Company's revenues from license fees resulting from sales through indirect channel partners were approximately 33%, 38%, and 31% of total revenues from license fees for the first nine months of fiscal years 2006, 2005 and 2004, respectively. The Company's ability to achieve significant revenue growth in the future will depend in large part on the success of its sales force in further establishing and maintaining relationships with indirect channel partners. In particular, a significant element of the Company's strategy is to embed its technology in products offered by OEMs for resale or as a hosted application to such OEMs' customers and end-users. The Company also intends to establish and expand its relationships with resellers and systems integrators so that such resellers and systems integrators will increasingly recommend its products to their clients. The Company's future success will depend on the ability of its indirect channel partners to sell and support its products. If the sales and implementation cycles of its indirect channel partners are lengthy or variable or its OEMs experience difficulties embedding its technology into their products or it fails to train the sales and customer support personnel of such indirect channel partners in a timely or effective fashion, the Company's business, operating results and financial condition would be harmed.

Although the Company is currently investing, and plans to continue to invest, significant resources to expand and develop relationships with OEMs, it has at times experienced and continues to experience difficulty in establishing and maintaining these relationships. If the Company is unable to successfully expand this distribution channel and secure license agreements with additional OEMs on commercially reasonable terms, including significant up-front payments of minimum license fees, and extend existing license agreements with existing OEMs on commercially reasonable terms, the Company's operating results would be adversely affected. Any inability by the Company to maintain existing or establish new relationships with indirect channel partners, including systems integrators and resellers, or, if such efforts are successful, a failure of the Company's revenues to increase correspondingly with expenses incurred in pursuing such relationships, would harm the Company's business, operating results and financial condition.

THE COMPANY MAY NOT BE ABLE TO COMPETE SUCCESSFULLY AGAINST ITS CURRENT AND FUTURE COMPETITORS.

The Company's market is intensely competitive and characterized by rapidly changing technology, evolving standards and product releases by the Company's competitors that are marketed to compete directly with the Company's products. The Company's competition comes in four principal forms:

- Competition from current or future business intelligence software vendors such as Business Objects, Cognos, Hyperion, Information Builders, and MicroStrategy, each of which offers enterprise reporting products;
- Competition from other large software vendors such as IBM, Microsoft, Oracle and SAP, to the extent they include reporting functionality with their applications or databases;
- Competition from other software vendors and software development tool vendors including providers of open-source software products; and
- Competition from the IT departments of current or potential customers that may develop scalable Enterprise Reporting Applications internally, which applications may be cheaper and more customized than the Company's products.

Most of the Company's current and potential competitors have significantly greater financial, technical, marketing and other resources than it does. These competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements or devote greater resources to the development, promotion and sales of their products than the Company may. Also, most current and potential competitors have greater name recognition and the ability to leverage a significant installed customer base. These companies have released and can continue to release competing enterprise reporting software products or significantly increase the functionality of their existing reporting software products, either of

[Table of Contents](#)

which could result in a loss of market share for the Company. The Company expects additional competition as other established and emerging companies enter the Enterprise Reporting Application market and new products and technologies are introduced. Increased competition could result in price reductions, fewer customer orders, reduced gross margins, longer sales cycles and loss of market share, any of which would harm the Company's business, operating results and financial condition.

Current and potential competitors may make strategic acquisitions or establish cooperative relationships among themselves or with third parties, thereby increasing their ability to address the needs of the Company's prospective customers. Also, the Company's current or future channel partners may have established in the past, or may in the future, establish cooperative relationships with the Company's current or potential competitors, thereby limiting the Company's ability to sell its products through particular distribution channels. It is possible that new competitors or alliances among current and new competitors may emerge and rapidly gain significant market share. Such competition could reduce the Company's revenues from license fees and services from new or existing customers on terms favorable to us. If the Company is unable to compete successfully against current and future competitors, the Company's business, operating results and financial condition would be harmed.

IF THE MARKET FOR ENTERPRISE REPORTING AND PERFORMANCE MANAGEMENT APPLICATION SOFTWARE DOES NOT GROW AS THE COMPANY EXPECTS, ITS BUSINESS WOULD BE SERIOUSLY HARMED.

The market for Enterprise Reporting and Performance Management Application software products is still emerging and the Company cannot be certain that such market will continue to grow or that, even if the market does grow, businesses will purchase the Company's products. If the market for Enterprise Reporting and Performance Management Application software products fails to grow or grows more slowly than the Company expects, its business, operating results and financial condition would be harmed. To date, all of the Company's revenues have been derived from licenses for its enterprise reporting and software and Performance Management application related products and services, and it expects this to continue for the foreseeable future. The Company has spent, and intends to continue to spend, considerable resources educating potential customers and indirect channel partners about Enterprise Reporting and Performance Management Applications and its products. However, if such expenditures do not enable its products to achieve any significant degree of market acceptance, the Company's business, operating results and financial condition would be harmed.

BECAUSE THE SALES CYCLES OF THE COMPANY'S PRODUCTS ARE LENGTHY AND VARIABLE, ITS QUARTERLY RESULTS MAY FLUCTUATE.

The purchase of the Company's products by its end-user customers for deployment within the customer's organization typically involves a significant commitment of capital and other resources, and is therefore subject to delays that are beyond the Company's control. These delays can arise from a customer's internal procedures to approve large capital expenditures, budgetary constraints, the testing and acceptance of new technologies that affect key operations and general economic and political events. The sales cycle for initial orders and larger follow-on orders for the Company's products can be lengthy and variable. Additionally, sales cycles for sales of the Company's products to OEMs tend to be longer, ranging from 6 to 24 months or more, and may involve convincing the OEMs' entire organization that the Company's products are the appropriate software for their applications. This time period does not include the sales and implementation cycles of such OEMs' own products, which can be longer than the Company's sales and implementation cycles. Certain of the Company's customers have in the past, or may in the future, experience difficulty completing the initial implementation of Actuate's products. Any difficulties or delays in the initial implementation by the Company's end-user customers or indirect channel partners could cause such customers to reject the Company's software or lead to the delay or non-receipt of future orders for the large-scale deployment of its products, in which case the Company's business, operating results and financial condition would be harmed.

ADVANCES IN HARDWARE TECHNOLOGY MAY CAUSE OUR SOFTWARE REVENUE TO DECLINE.

In the past, the Company has licensed software for a certain number of "processors" or "CPUs" to many of its customers. Advances in hardware technology, including, but not limited to, greater CPU clock speeds, multiple-core processors and virtualization, have afforded software performance gains to some customers, causing them to defer additional software purchases from the Company. The occurrence of any of these events, and other future advances, could seriously harm the Company's business, operating results and financial condition. Furthermore, in many cases, use of the software on such advanced hardware without payment of a transfer fee is prohibited by the terms of applicable license agreements or Company policies. The Company intends to require compliance with such terms and as a result of its enforcement efforts, customers may defer or cease purchasing additional software or maintenance and support. The occurrence of any of these events could seriously harm the Company's business, operating results and financial condition.

[Table of Contents](#)

IF THE COMPANY IS UNABLE TO FAVORABLY ASSESS THE EFFECTIVENESS OF ITS INTERNAL CONTROL OVER FINANCIAL REPORTING, IN FUTURE PERIODS, OR IF THE COMPANY'S INDEPENDENT AUDITORS ARE UNABLE TO PROVIDE AN UNQUALIFIED ATTESTATION REPORT ON SUCH ASSESSMENT, THE COMPANY'S STOCK PRICE COULD BE ADVERSELY AFFECTED.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 ("Section 404"), the Company's management is required to report on, and its independent auditors are required to attest to, the effectiveness of the Company's internal controls over financial reporting on an ongoing basis. The Company's assessment, testing and evaluation of the design and operating effectiveness of its internal control over financial reporting are ongoing. The Company identified one material weakness, which was disclosed in Item 9A of the Company's Annual Report on Form 10-K for the year ended December 31, 2004 as filed with the Securities and Exchange Commission on March 16, 2005, as amended by Form 10-K/A filed with the Securities and Exchange Commission on May 2, 2005. The Company cannot predict the outcome of its testing in future periods. If in future periods the Company concludes that its internal control over financial reporting is not effective, it may be required to change its internal control over financial reporting to remediate deficiencies, and investors may lose confidence in the reliability of its financial statements, causing the Company's stock price to decline.

SECTION 404 AND OTHER RECENTLY ENACTED REGULATORY CHANGES HAVE CAUSED THE COMPANY TO INCUR INCREASED COSTS AND OPERATING EXPENSES AND MAY MAKE IT MORE DIFFICULT FOR THE COMPANY TO ATTRACT AND RETAIN QUALIFIED OFFICERS AND DIRECTORS.

The Sarbanes-Oxley Act of 2002 and recently enacted rules of the SEC and Nasdaq have caused the Company to incur significant increased costs as it implements and responds to new requirements. In particular, the rules governing the standards that must be met for management to assess its internal controls over financial reporting under Section 404 are new and complex, and require significant documentation, testing and possible remediation. This ongoing process of reviewing, documenting and testing the Company's internal controls over financial reporting has resulted in, and will likely continue to result in, a significant strain on the Company's management, information systems and resources. Furthermore, achieving and maintaining compliance with Sarbanes-Oxley and other new rules and regulations has required the Company to hire additional personnel and has and will continue to require it to use additional outside legal, accounting and advisory services.

Any acquisitions made by the Company will also put a significant strain on its management, information systems and resources. In addition, any expansion of the Company's international operations will lead to increased financial and administrative demands associated with managing its international operations and managing an increasing number of relationships with foreign partners and customers and expanded treasury functions to manage foreign currency risks, all of which will require implementation of any changes necessary to maintain effective internal controls over financial reporting.

Any failure to satisfy the new rules could make it more difficult for the Company to obtain certain types of insurance, including director and officer liability insurance, and it may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. Alternatively, the Company may determine that it should reduce its director and officer liability insurance policy limits. The impact of any of these events could also make it more difficult for the Company to attract and retain qualified persons to serve on its Board of Directors, or as executive officers.

IF THE COMPANY DOES NOT RESPOND TO RAPID TECHNOLOGICAL CHANGES, ITS PRODUCTS COULD BECOME OBSOLETE.

The market for the Company's products is characterized by rapid technological changes, frequent new product introductions and enhancements, changing customer demands, and evolving industry standards. Any of these factors can render existing products obsolete and unmarketable. The Company believes that its future success will depend in large part on its ability to support current and future releases of popular operating systems and computer programming languages, databases and software applications, to timely develop new products that achieve market acceptance and to meet an expanding range of customer requirements. If the announcement or introduction of new products by the Company or its competitors or any change in industry standards causes customers to defer or cancel purchases of existing products, the Company's business, operating results and financial condition would be harmed.

As a result of the complexities inherent in Enterprise Reporting Applications and Performance Management Applications, major new products and product enhancements can require long development and testing periods. In addition, customers may delay their purchasing decisions in anticipation of the general availability of new or enhanced versions of the Company's products. As a result, significant delays in the general availability of such new releases or significant problems in the installation or implementation of such new releases could harm the Company's business, operating results and financial condition. If the Company fails to successfully develop, on a timely and cost effective basis, product enhancements or new products that respond to technological change, evolving industry standards or customer requirements or such new products and product enhancements fail to achieve market acceptance, the Company's business, operating results and financial condition would be harmed.

[Table of Contents](#)

IF THE COMPANY DOES NOT RELEASE NEW PRODUCTS AND ENHANCEMENTS TO EXISTING PRODUCTS IN A TIMELY MANNER OR IF SUCH NEW PRODUCTS AND ENHANCEMENTS, INCLUDING THE COMPANY'S OPEN SOURCE PROJECT, FAIL TO ACHIEVE MARKET ACCEPTANCE, THE COMPANY'S BUSINESS COULD BE SERIOUSLY HARMED.

The Company believes that its future success will depend in large part on the success of new products and enhancements to its products that it makes generally available. Prior to the release of any new products or enhancements, the products must undergo a long development and testing period. To date, the development and testing of new products and enhancements have taken longer than expected. In the event the development and testing of new products and enhancements continue to take longer than expected, the release of new products and enhancements will be delayed. If the Company fails to release new products and enhancements in a timely manner, its business, operating results and financial condition would be harmed. In addition, if such new products and enhancements do not achieve market acceptance, the Company's business, operating results and financial condition would be harmed.

The Company has developed a Business Intelligence Reporting Tools ("BIRT") open source code project as part of the Eclipse open source code foundation. The Company hopes that BIRT and a commercialized version of BIRT will be widely adopted by Java developers and will result in such developers recommending to their companies that they license the Company's commercially available products. If BIRT does not achieve market acceptance and result in promoting sales of commercially available products, the Company's business, operating results and financial condition may be harmed.

The Company has released performance software "Track" and portions of Actuate 9 and plans to release additional portions of Actuate 9 in the fourth quarter of 2006 and the first half of 2007. The Company hopes that our new product (Track) and the enhanced product (Actuate 9) will be introduced in a timely fashion and will be widely adopted and accepted by the Company's existing and new customers and OEM partners. If they are not, the Company's business, operating results and financial condition may be adversely affected.

THE SUCCESS OF THE COMPANY'S OPEN-SOURCE BIRT INITIATIVE IS DEPENDENT ON BUILDING A DEVELOPER COMMUNITY AROUND BIRT.

The success of the Company's BIRT initiative is dependent on the open source contributions of third-party programmers and corporations, and if they cease to make these contributions to the Eclipse open source project, the BIRT project, or the general open source movement, the Company's BIRT product strategy could be adversely affected. If key members, or a significant percentage, of this group of developers or corporations decides to cease development of Eclipse, BIRT or other open source applications, the Company would have to either rely on another party (or parties) to develop these technologies, develop them itself or adapt its open source product strategy accordingly. This could increase the Company's development expenses, delay its product releases and upgrades or adversely impact customer acceptance of open source offerings.

THE COMPANY'S INTERNATIONAL OPERATIONS ARE SUBJECT TO SIGNIFICANT RISKS.

A substantial portion of the Company's revenues is derived from international sales. International operations are subject to a number of risks, any of which could harm our business, operating results and financial conditions. These risks include the following:

- Economic and political instability, including war and terrorism or the threat of war and terrorism;
- Difficulty of managing an organization spread across many countries;
- Multiple and conflicting tax laws and regulations;
- Costs of localizing products for foreign countries;
- Difficulty in hiring employees and difficulties and high costs associated with terminating employees and restructuring operations in foreign countries;
- Trade laws and business practices favoring local competition;
- Dependence on local vendors;
- Compliance with multiple, conflicting and changing government laws and regulations;
- Weaker intellectual property protection in foreign countries and potential loss of proprietary information due to piracy or misappropriation;

Table of Contents

- Longer sales cycles;
- Import and export restrictions and tariffs;
- Difficulties in staffing and managing foreign operations;
- The significant presence of some of our competitors in certain international markets;
- Greater difficulty or delay in accounts receivable collection; and
- Foreign currency exchange rate fluctuations.

The Company believes that, over time, an increasing portion of its revenues and costs will be denominated in foreign currencies. To the extent such denomination in foreign currencies does occur, gains and losses on the conversion to U.S. dollars of accounts receivable, accounts payable and other monetary assets and liabilities arising from international operations may contribute to fluctuations in the Company's results of operations. Although the Company may in the future decide to undertake foreign exchange hedging transactions to cover a portion of its foreign currency transaction exposure, it currently does not attempt to cover any foreign currency exposure. If it is not effective in any future foreign exchange hedging transactions in which it engages, the Company's business, operating results and financial condition could be harmed.

THE COMPANY'S EXECUTIVE OFFICERS AND CERTAIN KEY PERSONNEL ARE CRITICAL TO ITS BUSINESS AND IT MAY NOT BE ABLE TO RECRUIT AND RETAIN THE PERSONNEL IT NEEDS.

The Company's future success depends upon the continued service of its executive officers and other key engineering, sales, marketing and customer support personnel. None of its officers or key employees is bound by an employment agreement for any specific term. If the Company loses the service of one or more of our key employees, or if one or more of our executive officers or key employees decide to join a competitor or otherwise compete directly or indirectly with it, this could have a significant adverse effect on the Company's business.

In addition, because experienced personnel in our industry are in high demand and competition for their talents is intense, the Company has relied on its ability to grant stock options as one mechanism for recruiting and retaining this highly skilled talent. Accounting regulations that have recently taken effect require the expensing of stock options, which will impair our future ability to provide these incentives without incurring significant compensation costs. There can be no assurance that the Company will continue to successfully attract and retain key personnel in the future.

CHANGES IN, OR INTERPRETATIONS OF, ACCOUNTING RULES AND REGULATIONS COULD RESULT IN UNFAVORABLE ACCOUNTING CHARGES.

The Company prepares its consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. These principles are subject to interpretation by the Securities and Exchange Commission (the "SEC") and various bodies formed to interpret and create appropriate accounting policies. A change in these policies can have a significant effect on the Company's reported results and may even retroactively affect previously reported transactions. The Company's accounting policies that recently have been or may be affected by changes in the accounting rules are as follows:

- Software revenue recognition;
- Accounting for income taxes;
- Accounting for business combinations and related goodwill; and
- Accounting for stock issued to employees.

THE COMPANY MAY BE UNABLE TO SUSTAIN OR INCREASE ITS PROFITABILITY.

While the Company was profitable in its last two fiscal years, it incurred net losses during fiscal year 2003 and 2002. Its ability to sustain or increase profitability on a quarterly or annual basis will be affected by changes in its business. It expects its operating expenses to increase as its business grows, and it anticipates that it will make investments in its business. Therefore, the Company's results of operations will be harmed if its revenues do not increase at a rate equal to or greater than increases in its expenses or are insufficient for it to sustain profitability.

[Table of Contents](#)

IF THE COMPANY OVERESTIMATES REVENUES, IT MAY BE UNABLE TO REDUCE ITS EXPENSES TO AVOID OR MINIMIZE A NEGATIVE IMPACT ON ITS RESULTS OF OPERATIONS.

The Company's revenues are difficult to forecast and are likely to fluctuate significantly from period to period. The Company bases its operating expense budgets on expected revenue trends. The Company's estimates of sales trends may not correlate with actual revenues in a particular quarter or over a longer period of time. Variations in the rate and timing of conversion of the Company's sales prospects into actual licensing revenues could cause it to plan or budget inaccurately and those variations could adversely affect the Company's financial results. In particular, delays, reductions in amount or cancellation of customers' purchases would adversely affect the overall level and timing of the Company's revenues and its business, results of operations and financial condition could be harmed. In addition, many of its expenses, such as office and equipment leases and certain personnel costs, are relatively fixed. It may be unable to adjust spending quickly enough to offset any unexpected revenue shortfall. Accordingly, any shortfall in revenue may cause significant variation in operating results in any period.

IF THE COMPANY'S PRODUCTS CONTAIN MATERIAL DEFECTS, ITS REVENUES MAY DECLINE.

Software products as complex as those offered by the Company often contain errors or defects, particularly when first introduced, when new versions or enhancements are released and when configured to individual customer computing systems. The Company currently has known errors and defects in its products. Despite testing conducted by the Company, if additional defects and errors are found in current versions, new versions or enhancements of its products after commencement of commercial shipment, this could result in the loss of revenues or a delay in market acceptance or an increase in the rate of return of the Company's products. The occurrence of any of these events could seriously harm the Company's business, operating results and financial condition.

THE COMPANY MAY BE SUBJECT TO PRODUCT LIABILITY CLAIMS.

Although license agreements with our customers typically contain provisions designed to limit the Company's exposure to potential product liability claims, it is possible that such limitation of liability provisions may not be effective as a result of existing or future laws or unfavorable judicial decisions. The sale and support of the Company's products may entail the risk of such claims, which are likely to be substantial in light of the use of its products in business-critical applications. A product liability claim brought against the Company could seriously harm its business, operating results and financial condition.

THE PROTECTION OF OUR PROPRIETARY RIGHTS MAY BE INADEQUATE.

The Company has a small number of issued and pending U.S. patents expiring at varying times ranging from 2015 to 2019. The Company relies primarily on a combination of copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect its proprietary technology. For example, the Company licenses its software pursuant to shrink- or click-wrap or signed license agreements that impose certain restrictions on licensees' ability to utilize the software. In addition, the Company seeks to avoid disclosure of its intellectual property, including by requiring those persons with access to its proprietary information to execute confidentiality agreements with the Company and by restricting access to its source code. The Company takes precautions to protect our software, certain documentation, and other written materials under trade secret and copyright laws, which afford only limited protection.

Despite the Company's efforts to protect its proprietary rights, unauthorized parties may attempt to copy aspects of its products or to obtain and use information that the Company regards as proprietary. Policing unauthorized use of the Company's products is difficult, and while it is unable to determine the extent to which piracy of its software products exists, software piracy can be expected to be a persistent problem. In addition, the laws of many countries do not protect the Company's proprietary rights to as great an extent as do the laws of the United States. If the Company's means of protecting its proprietary rights is not adequate or its competitors independently develop similar technology, the Company's business could be seriously harmed.

THE COMPANY'S COMMON STOCK PRICE MAY BE VOLATILE, WHICH COULD RESULT IN SUBSTANTIAL LOSSES FOR STOCKHOLDERS.

The market price of shares of the Company's common stock has been and is likely to continue to be highly volatile and may be significantly affected by factors such as the following:

- Actual or anticipated fluctuations in its operating results;
- Changes in the economic and political conditions in the United States and abroad;
- Terrorist attacks, war or the threat of terrorist attacks and war;

Table of Contents

- The announcement of mergers or acquisitions by the Company or its competitors;
- Developments in ongoing or threatened litigation;
- Announcements of technological innovations;
- Failure to comply with the requirements of Section 404 of the Sarbanes-Oxley Act;
- New products, including open source products, or new contracts announced by it or its competitors;
- Developments with respect to copyrights or proprietary rights;
- Price and volume fluctuations in the stock market;
- Changes in corporate purchasing of Enterprise Reporting Application software;
- Adoption of new accounting standards affecting the software industry (including stock option-expensing roles); and
- Changes in financial estimates by securities analysts.

In addition, following periods of volatility in the market price of a particular company's securities, securities class action litigation has often been brought against such companies. If the Company is involved in such litigation, it could result in substantial costs and a diversion of management's attention and resources and could harm the Company's business, operating results and financial condition.

CHANGES IN TAX RATES OR NEGATIVE TAX RULINGS COULD ADVERSELY IMPACT THE COMPANY'S FINANCIAL RESULTS.

The Company is taxable principally in the United States and certain jurisdictions in Europe and Asia/Pacific. All of these jurisdictions have in the past and may in the future make changes to their corporate income tax rates and other income tax laws, which could increase the Company's future income tax provision. While the Company believes that all material income tax liabilities are reflected properly in its balance sheet, it has no assurance that it will prevail in all cases in the event the taxing authorities disagree with its interpretations of the tax law. Future levels of research and development spending will impact the Company's entitlement to related tax credits, which generally lower its effective income tax rate. Future effective income tax rates could be adversely affected if earnings are lower than anticipated in jurisdictions where the Company has statutory tax rates lower than in the United States.

CERTAIN OF THE COMPANY'S CHARTER PROVISIONS AND DELAWARE LAW MAY PREVENT OR DETER A CHANGE IN CONTROL OF ACTUATE.

The Company's Certificate of Incorporation, as amended and restated (the "Certificate of Incorporation"), and Bylaws, as amended and restated ("Bylaws"), contain certain provisions that may have the effect of discouraging, delaying or preventing a change in control of the Company or unsolicited acquisition proposals that a stockholder might consider favorable, including provisions authorizing the issuance of "blank check" preferred stock and eliminating the ability of stockholders to act by written consent. In addition, certain provisions of Delaware law and the Company's stock option plans may also have the effect of discouraging, delaying or preventing a change in control or unsolicited acquisition proposals. The anti-takeover effect of these provisions may also have an adverse effect on the public trading price of the Company's common stock

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The table below sets forth information regarding repurchases of Actuate common stock by Actuate during the three months ended September 30, 2006.

Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased	Average price paid per share	Total number of shares purchased as part of publicly announced programs (1)	Maximum dollar value of shares that may yet be purchased under the program (1)
<u>Month #1</u>				
July 1, 2006 through July 31, 2006	—	—	—	—
<u>Month #2</u>				
August 1, 2006 through August 31, 2006	393,186	\$ 3.78	393,186	—
<u>Month #3</u>				
September 1, 2006 through September 30, 2006	—	—	—	—
Total	<u>393,186</u>	<u>\$ 3.78</u>	<u>393,186</u>	<u>—</u>

- (1) On September 19, 2001, the Company's Board of Directors authorized a stock repurchase program of up to \$6.0 million of our common stock. On October 24, 2002 and April 28, 2004 Actuate's Board of Directors extended the stock repurchase program by authorizing management to repurchase up to an additional \$3.0 million and \$1.5 million worth of Company's common stock, respectively. On July 28, 2004, the Company's Board of Directors authorized management to repurchase, on an on-going basis, up to \$1.5 million Actuate common stock each calendar quarter. During the fourth quarter of 2004, the Board of Directors suspended the repurchase program.

In January 2005, pursuant to the stock repurchase program announced in September 2001, and extended from time to time by the Company's Board of Directors, the Board of Directors approved an on-going extension of the Company's stock repurchase program. This was further confirmed in April 2005, July 2005 and October 2005 when the Board of Directors authorized management to proceed with the repurchases. The Company is authorized to repurchase Actuate common stock in an amount not to exceed cash flow from operations during the prior quarter, with the actual amount to be approved in advance by the Board.

Item 6. Exhibits

- 31.1 Rule 13a-14(a)/15d-14(a) Certification of the Chief Executive Officer
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of the Chief Financial Officer
- 32.1 Section 1350 Certifications

[Table of Contents](#)

Signature

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

Dated: November 9, 2006

Actuate Corporation

(Registrant)

By: /s/ DANIEL A. GAUDREAU

Daniel A. Gaudreau

Chief Financial Officer, Senior Vice

President of Finance (Principal Financial

and Accounting Officer)

Certification

I, Peter I. Cittadini, President and Chief Executive Officer, certify that:

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

Dated: November 9, 2006

/s/ Peter I. Cittadini

Peter I. Cittadini

President and Chief Executive Officer

(Principal Executive Officer)

Certification

I, Daniel A. Gaudreau, Chief Financial Officer and Senior Vice President of Finance and Administration, certify that:

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

Dated: November 9, 2006

/s/ Daniel A. Gaudreau

Daniel A. Gaudreau

Senior Vice President, Finance and Administration and

Chief Financial Officer

(Principal Financial and Accounting Officer)

Section 1350 Certifications

In connection with the Quarterly Report on Form 10-Q of Actuate Corporation (the "Company") for the period ended September 30, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, the Chief Executive Officer of the Company and the Chief Financial Officer of the Company, each hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to his knowledge on the date hereof, the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: November 9, 2006

/s/ Peter I. Cittadini

Peter I. Cittadini

President and Chief Executive Officer

(Principal Executive Officer)

/s/ Daniel A. Gaudreau

Daniel A. Gaudreau

Senior Vice President, Finance and Administration and

Chief Financial Officer

(Principal Financial and Accounting Officer)