

ULTIMATE SOFTWARE GROUP INC

Form 10-Q

November 08, 2006

Table of Contents

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q**

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

For the quarterly period ended September 30, 2006

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

For the transition period from _____ to _____

Commission file number: 0-24347

THE ULTIMATE SOFTWARE GROUP, INC.

(Exact name of Registrant as specified in its charter)

Delaware

65-0694077

(State or other jurisdiction of
incorporation
or organization)

(I.R.S. Employer Identification No.)

2000 Ultimate Way, Weston, FL

33326

(Address of principal executive
offices)

(Zip Code)

(954) 331 - 7000

(Registrant's telephone number, including area code)

None

(Former name, former address and former fiscal year, if changed since last report)

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. (Check one):

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

As of October 23, 2006, there were 24,074,351 shares of the Registrant's Common Stock, par value \$.01, outstanding.

Table of Contents

**THE ULTIMATE SOFTWARE GROUP, INC. AND SUBSIDIARIES
TABLE OF CONTENTS**

	Page(s)
<u>Part I Financial Information:</u>	
<u>Item 1 Financial Statements:</u>	
<u>Unaudited Condensed Consolidated Balance Sheets as of September 30, 2006 and December 31, 2005</u>	3
<u>Unaudited Condensed Consolidated Statements of Operations for the Three Months and Nine Months Ended September 30, 2006 and 2005</u>	4
<u>Unaudited Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2006 and 2005</u>	5
<u>Unaudited Condensed Consolidated Statements of Stockholders' Equity for the Nine Months Ended September 30, 2006</u>	6
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	7-17
 <u>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	 18-33
 <u>Item 3 Quantitative and Qualitative Disclosures About Market Risk</u>	 34
 <u>Item 4 Controls and Procedures</u>	 35
 <u>Part II Other Information:</u>	
 <u>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</u>	 35
 <u>Item 6 Exhibits</u>	 36
 <u>Signatures</u>	 37
<u>Certifications</u>	
<u>EX-10.37 Lease of Office Space</u>	
<u>EX-10.38 Indemnity Agreement</u>	
<u>EX-31.1 Section 302 Certification of CEO</u>	
<u>EX-31.2 Section 302 Certification of CFO</u>	
<u>EX-32.1 Section 906 Certification of CEO</u>	
<u>EX-32.2 Section 906 Certification of CFO</u>	

Table of Contents**Item 1 Financial Statements**

PART 1 FINANCIAL INFORMATION
THE ULTIMATE SOFTWARE GROUP, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except share and per share data)

	As of September 30, 2006	As of December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 14,310	\$ 17,731
Accounts receivable, net of allowance for doubtful accounts of \$500 for 2006 and 2005, respectively	20,589	18,126
Short-term investments in marketable securities	16,389	14,422
Prepaid expenses and other current assets	7,263	5,526
Total current assets	58,551	55,805
Property and equipment, net	12,476	10,026
Capitalized software, net	1,522	238
Long-term investments in marketable securities	1,199	613
Other assets, net	5,143	2,899
Total assets	\$ 78,891	\$ 69,581
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 3,803	\$ 2,613
Accrued expenses	7,011	6,406
Current portion of deferred revenue	31,832	29,385
Current portion of capital lease obligations	1,362	1,393
Current portion of long-term debt	505	338
Total current liabilities	44,513	40,135
Deferred revenue, net of current portion	5,340	3,646
Deferred Rent	1,025	426
Capital lease obligations, net of current portion	1,183	966
Long-term debt, net of current portion	319	862
Total liabilities	52,380	46,035
Stockholders equity:		

Edgar Filing: ULTIMATE SOFTWARE GROUP INC - Form 10-Q

Preferred Stock, \$.01 par value, 2,000,000 shares authorized, no shares issued or outstanding		
Series A Junior Participating Preferred Stock, \$.01 par value, 500,000 shares authorized, no shares issued or outstanding		
Common Stock, \$.01 par value, 50,000,000 shares authorized, 24,762,038 and 23,786,097 shares issued in 2006 and 2005, respectively	248	238
Additional paid-in capital	120,629	110,245
Accumulated other comprehensive loss	2	(31)
Accumulated deficit	(83,517)	(85,852)
	37,362	24,600
Treasury stock, 709,437 and 257,647 shares, at cost, for 2006 and 2005, respectively	(10,851)	(1,054)
Total stockholders' equity	26,511	23,546
Total liabilities and stockholders' equity	\$ 78,891	\$ 69,581

The accompanying Notes to Unaudited Condensed Consolidated Financial Statements are an integral part of these financial statements.

Table of Contents

THE ULTIMATE SOFTWARE GROUP, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenues:				
Recurring	\$ 16,487	\$ 12,956	\$ 46,456	\$ 36,685
Services	9,410	6,484	25,972	19,049
License	2,882	2,746	9,340	7,909
Total revenues	28,779	22,186	81,768	63,643
Cost of revenues:				
Recurring	4,602	3,588	13,040	10,024
Services	7,287	5,171	20,655	14,991
License	319	165	966	464
Total cost of revenues	12,208	8,924	34,661	25,479
Gross Profit	16,571	13,262	47,107	38,164
Operating expenses:				
Sales and marketing	7,222	5,523	21,711	15,980
Research and development	5,887	5,251	16,533	15,238
General and administrative	2,526	1,945	7,524	5,701
Total operating expenses	15,635	12,719	45,768	36,919
Operating income	936	543	1,339	1,245
Interest expense	(52)	(65)	(152)	(181)
Interest and other income	419	223	1,148	526
Net income	\$ 1,303	\$ 701	\$ 2,335	\$ 1,590
Net income per share:				
Basic	\$ 0.05	\$ 0.03	\$ 0.10	\$ 0.07
Diluted	\$ 0.05	\$ 0.03	\$ 0.09	\$ 0.06
Weighted average shares outstanding:				
Basic	24,130	23,229	23,713	22,899

Diluted	27,030	26,566	26,891	26,112
---------	--------	--------	--------	--------

The accompanying Notes to Unaudited Condensed Consolidated Financial Statements are an integral part of these financial statements.

4

Table of Contents

THE ULTIMATE SOFTWARE GROUP, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	For the Nine Months Ended September 30,	
	2006	2005
Cash flows from operating activities:		
Net income	\$ 2,335	\$ 1,590
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,727	3,326
Provision for doubtful accounts	873	489
Non-cash stock-based compensation expense	4,128	156
Changes in operating assets and liabilities:		
Accounts receivable	(3,336)	(1,957)
Prepaid expenses and other current assets	(1,737)	(1,572)
Other assets	(2,244)	(488)
Accounts payable	1,190	81
Accrued expenses and other long term liabilities	1,204	(623)
Deferred revenue	4,141	1,608
Net cash provided by operating activities	10,281	2,610
Cash flows from investing activities:		
Purchases of marketable securities	(17,903)	(13,302)
Maturities of marketable securities	15,383	12,770
Capitalized software	(1,273)	
Purchases of property and equipment	(4,725)	(2,429)
Net cash used in investing activities	(8,518)	(2,961)
Cash flows from financing activities:		
Repurchases of Common Stock	(9,797)	
Principal payments on capital lease obligations	(1,247)	(939)
Net payments on long term debt	(376)	334
Net proceeds from issuances of Common Stock	6,236	4,537
Net cash (used in) provided by financing activities	(5,184)	3,932
Net (decrease) increase in cash and cash equivalents	(3,421)	3,581
Cash and cash equivalents, beginning of period	17,731	14,766
Cash and cash equivalents, end of period	\$ 14,310	\$ 18,347

Supplemental disclosure of cash flow information:

Cash paid for interest	\$	79	\$	82
------------------------	----	----	----	----

Supplemental disclosure of non-cash financing activities:

The Company entered into capital lease obligations to acquire new equipment totaling \$1,433 and \$1,706 for the nine months ended September 30, 2006 and 2005, respectively.

The accompanying Notes to Unaudited Condensed Consolidated Financial Statements are an integral part of these financial statements.

Table of Contents

THE ULTIMATE SOFTWARE GROUP, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands)

	Common Stock		Additional Paid-in Capital	Accumulated Comprehensive Loss	Accumulated Deficit	Treasury Stock		Total Stockholders' Equity
	Shares	Amount				Shares	Amount	
Balance, December 31, 2005	23,786	\$238	\$110,245	\$ (31)	\$(85,852)	258	\$ (1,054)	\$23,546
Net income					2,335			2,335
Unrealized gain on investments in marketable securities available-for-sale				33				33
Comprehensive income								2,368
Repurchases of Common Stock						451	(9,797)	(9,797)
Issuances of Common Stock from exercises of stock options and warrants	976	10	6,226					6,236
Non-cash stock-based compensation			4,158					4,158
Balance, September 30, 2006	24,762	\$248	\$120,629	\$ 2	\$(83,517)	709	\$(10,851)	\$26,511

Table of Contents

**THE ULTIMATE SOFTWARE GROUP, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of The Ultimate Software Group, Inc. and subsidiaries (the Company) have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC). Certain information and footnote disclosures normally included in financial statements in accordance with generally accepted accounting principles in the United States (GAAP) have been condensed or omitted pursuant to such rules and regulations. The information in this report should be read in conjunction with the Company's audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005 filed with the SEC on March 15, 2006 (the Form 10-K).

The unaudited condensed consolidated financial statements included herein reflect all adjustments (consisting only of normal, recurring adjustments), which are, in the opinion of the Company's management, necessary for a fair presentation of the information for the periods presented. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Interim results of operations for the three and nine months ended September 30, 2006 and 2005 are not necessarily indicative of operating results for the full fiscal years or for any future periods.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Investments in Marketable Securities

The Company classifies its investments in marketable securities with readily determinable fair values as securities available-for-sale in accordance with Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115) and FASB Staff Position Financial Accounting Standards No. 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1 and FAS 124-1). The Company has classified all investments as available-for-sale. Available-for-sale securities consist of debt and equity securities not classified as trading securities or as securities to be held to maturity. Unrealized holding gains and losses on securities available-for-sale are reported as a net amount in accumulated other comprehensive loss in stockholders' equity until realized. Gains and losses on the sale of securities available-for-sale are determined using the specific identification method. Included in accumulated other comprehensive income at September 30, 2006 and 2005 are \$1,846 and \$(37,628), respectively, of unrealized gains/(losses) on trading securities held at each such date.

Table of Contents

The amortized cost and market value of the Company's investments in marketable securities available-for-sale at September 30, 2006 are shown in the table below (in thousands).

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Market Value
Investments in marketable securities:				
U.S. Agency non callable	\$ 899	\$	\$ 2	\$ 897
Asset-backed fixed	595			595
Commercial paper.	2,384			2,384
Corporate debentures bonds	11,265	5	6	11,264
Certificates of deposit	2,449		1	2,448
Total investments, available-for-sale	\$17,592	\$ 5	\$ 9	\$17,588

The amortized cost and estimated fair value of the available-for-sale securities by contractual maturity at September 30, 2006 are shown below (in thousands):

	Amortized Cost	Estimated Fair Value
Due in one year or less	\$16,395	\$16,389
Due after one year	1,197	1,199
	\$17,592	\$17,588

Property and Equipment

Property and equipment is stated at cost, net of accumulated depreciation and amortization. Property and equipment is depreciated using the straight-line method over the estimated useful lives of the assets, which range from two to twenty years. Leasehold improvements and assets under capital leases are amortized over the shorter of the life of the asset or the term of the lease over periods ranging from two to fifteen years. Maintenance and repairs are charged to expense when incurred; betterments are capitalized. Upon the sale or retirement of assets, the cost, accumulated depreciation and amortization are removed from the accounts and any gain or loss is recognized.

Property and equipment consists of the following (in thousands):

	As of September 30, 2006	As of December 31, 2005
Property and equipment	\$ 38,590	\$ 32,453
Less: accumulated depreciation and amortization	26,114	22,427
	\$ 12,476	\$ 10,026

Rental Costs Incurred during a Construction Period

Effective January 1, 2006, the Company adopted FSP FAS 13-1, Accounting for Rental Costs Incurred during a Construction Period, which addresses the accounting for rental costs associated with operating leases that are incurred during a construction period. Rental costs incurred during and after a construction period are for the right to control the use of a leased asset during and after construction of a leased asset. Since there is no distinction between the right to use a leased asset during the construction period and the right to use that asset after the construction period, rental

costs associated with ground or building operating leases that are incurred during a construction period shall be recognized as rental expense on a straight-line basis. The adoption of FSP FAS 13-1 did not have a material impact on the Company's unaudited condensed consolidated financial statements.

Table of Contents**Stock-Based Compensation**

Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123 (revised 2004), Share-Based Payment (SFAS No. 123R), using the modified prospective method (with the Black-Scholes fair value model), which requires the Company to recognize expense related to the fair value of stock-based compensation awards. Under the modified prospective method, stock-based compensation expense for the three and nine months ended September 30, 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of, January 1, 2006, based on grant date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123), and compensation expense for all stock-based compensation awards granted subsequent to January 1, 2006, based on the grant date fair values estimated in accordance with the provisions of SFAS No. 123R. In addition, stock options granted to certain members of the Board of Directors (Board) as payment for services rendered as board members (Board Services) recorded in accordance with SFAS No. 123R and the issuance of restricted stock awards and stock units to certain employees are also included in stock-based compensation for the three and nine months ended September 30, 2006. Accordingly, prior period amounts presented herein have not been restated to reflect the adoption of SFAS No. 123R.

Prior to January 1, 2006, the Company accounted for its stock-based compensation plan as permitted by SFAS No. 123, using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25), and made the pro forma disclosures required by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (SFAS No. 148) for the three and nine months ended September 30, 2005. Except for options granted to certain members of the Board for Board Services, all options granted under the Plan and Prior Plan (discussed in Note 3) had exercise prices equal to the fair market value of the underlying Common Stock on the date of grant. Accordingly, for the three and nine months ended September 30, 2005, stock-based compensation is related to options granted to certain members of the Board for Board Services and the issuance of restricted stock awards to certain employees recorded in accordance with APB No. 25.

In accordance with SFAS No. 123R, the Company capitalizes the portion of stock-based compensation expense attributed to research and development personnel whose labor costs are being capitalized pursuant to SFAS No. 86,

Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed, for the development of UltiPro Canadian HR/payroll (UltiPro Canada) functionality. UltiPro Canada is being built from the existing product infrastructure of UltiPro (e.g., using UltiPro s source code and architecture). UltiPro Canada will provide HR/payroll functionality which includes the availability of Canadian tax rules, as well as Canadian human resources functionality, taking into consideration labor laws in Canada and including changes to the language where necessary (i.e., English to French). The following table summarizes stock-based compensation related to the development of UltiPro Canada (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
Stock-based compensation Statement of operations	\$1,415	\$71	\$4,128	\$156
Stock-based compensation Capitalized software (UltiPro Canada)	6		30	
Stock-based compensation Statement of stockholders' equity	\$1,421	\$71	\$4,158	\$156

Table of Contents**Earnings Per Share**

SFAS No. 128, Earnings Per Share, requires dual presentation of earnings per share basic and diluted. Basic earnings per share is computed by dividing income available to common stockholders (the numerator) by the weighted average number of common shares outstanding (the denominator) for the period. The computation of diluted earnings per share is similar to basic earnings per share, except that the denominator is increased to include the number of additional common shares that would have been outstanding if the potentially dilutive common shares had been issued.

The following is a reconciliation of the shares used in the computation of basic and diluted net income per share (in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2006	2005	2006	2005
Basic weighted average shares outstanding	24,130	23,229	23,713	22,899
Effect of dilutive equity instruments	2,900	3,337	3,178	3,213
Dilutive weighted average shares outstanding	27,030	26,566	26,891	26,112
Other common stock equivalents (i.e., stock options, restricted stock awards, stock units and warrants) outstanding which are not included in the calculation of diluted income per share because their impact is antidilutive	523	281	383	706

Comprehensive Income

SFAS No. 130, Reporting Comprehensive Income, establishes standards for the reporting and display of comprehensive income and its components in the Company's unaudited condensed consolidated financial statements. The objective of SFAS No. 130 is to report a measure (comprehensive income) of all changes in equity of an enterprise that result from transactions and other economic events in a period other than transactions with owners. Accumulated other comprehensive income, as presented on the accompanying unaudited condensed consolidated balance sheets, consists entirely of unrealized gains on available-for-sale securities.

Comprehensive income for the three and nine months ended September 30, 2006 and 2005 was as follows (in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2006	2005	2006	2005
Net income	\$1,303	\$701	\$2,335	\$1,590
Other comprehensive income:				
Unrealized income (loss) on investments in marketable securities available-for-sale	42	(7)	33	(23)

Comprehensive income	\$1,345	\$694	\$2,368	\$1,567
----------------------	---------	-------	---------	---------

10

Table of Contents**Guarantees**

The Company adopted FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, (FIN 45) on January 1, 2003. The provision for initial recognition and measurement of liability is applied on a prospective basis to guarantees issued or modified after December 31, 2002. FIN 45 expands previously issued accounting guidance and disclosure requirements for certain guarantees and requires recognition of an initial liability for the fair value of an obligation assumed by issuing a guarantee. As an element of standard commercial terms in its standard sales contracts for UltiPro, the Company includes an indemnification clause that indemnifies the customer against certain liabilities and damages arising from any claims of patent, copyright, or other proprietary rights of any third party. Due to the nature of the intellectual property indemnification provided to its customers, the Company cannot estimate the fair value, or determine the total nominal amount, of the indemnification until such time as a claim for such indemnification is made. In the event of a claim made against the Company under such provision, the Company evaluates estimated losses for such indemnification under SFAS No. 5, *Accounting for Contingencies*, as interpreted by FIN 45, considering such factors as the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. To date, the Company has not had any claims made against it under such provision and, accordingly, has not accrued any liabilities related to such indemnifications in its unaudited condensed consolidated financial statements.

Reclassifications

Certain amounts in the prior year balance sheets have been reclassified to conform to the 2006 presentation.

3. STOCK-BASED COMPENSATION**Summary of Plans**

The Company's 2005 Equity and Incentive Plan (the Plan) authorizes the grant of options to directors, officers and employees of the Company to purchase shares of the Company's common stock, par value \$0.01 per share (the Common Stock). The Plan also authorizes the grant to such persons of restricted and non-restricted shares of Common Stock, stock appreciation rights, stock units and cash performance awards (collectively, and together with stock options, the Awards). The Plan was approved by the Company's stockholders at the annual meeting of stockholders on May 17, 2005. Prior to that date, options to purchase shares of Common Stock were issued under the Company's Nonqualified Stock Option Plan (the Prior Plan). Effective May 17, 2005, no additional options may be granted under the Prior Plan. However, options previously granted under the Prior Plan remain outstanding to the extent they have not been exercised and have not expired. The aggregate number of shares of Common Stock authorized under the Plan and the Prior Plan is 9,000,000. As of September 30, 2006, the aggregate number of shares of Common Stock that were available to be issued under all Awards granted under the Plan was 884,293 shares. Options granted to officers and employees under the Plan and the Prior Plan generally have a 10-year term, vesting 25% immediately and 25% on the anniversary of the grant date for each of the following three years. Options granted to non-employee directors under the Plan and the Prior Plan generally have a 10-year term and vest immediately on the grant date. However, options granted to non-employee directors for Board Services under the Plan first become exercisable on the earliest of (i) the fifth anniversary of the date of grant, (ii) the date on which the director ceases to be a member of the Board of Directors or (iii) the effective date of a change in control of the Company.

Table of Contents**Fair Value**

On January 1, 2006, the Company adopted the provisions of SFAS No. 123R, which requires the Company to recognize expense related to the fair value of stock-based compensation awards. The Company elected the modified prospective transition method as permitted by SFAS No. 123R and therefore has not restated the financial results for prior periods. Under the modified prospective method, stock-based compensation expense for the three and nine months ended September 30, 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of, January 1, 2006, based on grant date fair value estimated in accordance with the provisions of SFAS No. 123 and compensation expense for all stock-based compensation awards granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. In addition, options granted to certain members of the Board of Directors for Board Services recorded in accordance with SFAS No. 123R and the issuance of restricted stock awards and stock units are also included in stock-based compensation for the three and nine months ended September 30, 2006. The Company recognizes compensation expense for restricted stock awards and restricted stock units on a straight-line basis over the requisite service period of the award.

The following table sets forth the stock-based compensation expense resulting from share-based arrangements that is recorded in the Company's unaudited condensed consolidated statements of operations for the periods indicated (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
Cost of recurring revenues	\$ 89	\$	\$ 289	\$
Cost of service revenues	157		605	
Cost of license revenues	1		5	
Sales and marketing	788	32	2,035	44
Research and development	117		413	
General and administrative	263	\$39	781	\$112
Total	\$1,415	\$71	\$4,128	\$156

Included in capitalized software in the Company's unaudited condensed consolidated balance sheet at September 30, 2006 was \$30 thousand in stock-based compensation incurred in the development of UltiPro Canada during the first nine months of 2006. This amount would have otherwise been charged to research and development expense for the nine months ended September 30, 2006.

Net cash proceeds from the exercise of stock options and warrants were \$0.9 million and \$6.2 million for the three and nine months ended September 30, 2006, respectively, and \$0.9 million and \$4.5 million for the three and nine months ended September 30, 2005, respectively. No income tax benefit was realized from stock option exercises during the three and nine months ended September 30, 2006 and September 30, 2005.

Prior to January 1, 2006, the Company accounted for its stock-based compensation plan as permitted by SFAS No. 123, using the intrinsic value method prescribed in APB No. 25, and made the pro forma disclosures required by SFAS No. 148 for the three and six months ended June 30, 2005. Except for options granted to certain members of the Board for Board Services, all options granted under the Plan and Prior Plan had exercise prices equal to the fair market value of the underlying Common Stock on the date of grant. Accordingly, for the three and nine months ended September 30, 2005, stock-based compensation is related to options granted to certain members of the Board for Board Services recorded in accordance with APB No. 25.

Table of Contents

The following table illustrates the effect on net income (loss) after tax and net income (loss) per share of Common Stock as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation during the three and nine months ended September 30, 2005 (in thousands, except per share amounts):

	For the Three Months Ended September 30, 2005	For the Nine Months Ended September 30, 2005
Net income:		
As reported	\$ 701	\$ 1,590
Deduct: Stock-based compensation expense, pro forma	(786)	(2,286)
Net loss, pro forma	\$ (85)	\$ (696)
Net income (loss) per share, basic:		
As reported	\$ 0.03	\$ 0.07
Stock-based compensation expense, pro forma	(0.03)	(0.10)
Net loss per share, basic and diluted, pro forma	\$	\$ (0.03)
Net income (loss) per share, diluted:		
As reported	\$ 0.03	\$ 0.06
Stock-based compensation expense, pro forma	(0.03)	(0.09)
Net loss per share, basic and diluted, pro forma	\$	\$ (0.03)

The fair value of stock-based awards was estimated using the Black-Scholes model with the following weighted-average assumptions for the three and nine months ended September 30, 2006 and September 30, 2005 (dollars in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
Expected term (in years)	4.66	4.0	4.55	4.0
Volatility	40.7%	43%	40.2%	43%
Interest rate	4.875%	3.90%	4.79%	3.90%
Dividend yield				
Forfeiture rate (1)	4.90%		5.23%	
Weighted average fair value at grant date	\$ 7.85	\$6.52	\$8.61	\$5.79

- (1) The application of an estimated forfeiture rate was not applicable under

SFAS No. 123
as the true-up of
the pro forma
compensation
expense was
applied based
upon actual
forfeitures of
options.

The Company's computation of the expected volatility for the three and nine months ended September 30, 2006 is based primarily upon historical volatility and the expected term of the option. The expected term is based on the historical exercise experience under the share-based plans of the underlying award (including post-vesting employment termination behavior) and represents the period of time the share-based awards are expected to be outstanding. The interest rate is based on the U.S. Treasury yield in effect at the time of grant for a period commensurate with the estimated expected life. The forfeiture rate is based on historical data.

Table of Contents**Restricted Stock Awards**

Under the provisions of the Plan, the Company may, at its discretion, grant restricted stock awards to certain officers and employees (Restricted Stock Awards). The shares of Common Stock issued under Restricted Stock Awards are subject to certain vesting requirements and restrictions on transfer. During the three months ended September 30, 2006, there were no grants of Restricted Stock Awards. During the nine months ended September 30, 2006, the Company granted Restricted Stock Awards for 105,000 shares of Common Stock of which none has been forfeited as of September 30, 2006. During the three and nine months ended September 30, 2005, the Company granted Restricted Stock Awards for 35,000 shares of Common Stock of which none has been forfeited as of September 30, 2006. Compensation expense for Restricted Stock Awards is measured based on the closing market price of the Company's Common Stock at the date of grant and is recognized on a straight-line basis over the vesting period. Holders of Restricted Stock Awards have all rights of a stockholder including the right to vote the shares and receive all dividends and other distributions paid or made with respect thereto. Each Award becomes vested on the fourth anniversary of the respective date of grant, subject to the grantee's continued employment with the Company or any of its subsidiaries on each such vesting date and subject further to accelerated vesting in the event of a change in control of the Company, the employee's death or disability or the termination of his employment by the Company without cause. Included in the Company's financial results for the three and nine months ended September 30, 2006 was \$0.3 million and \$0.9 million, respectively, of compensation expense for Restricted Stock Awards. There was \$35,000 and \$52,000, respectively, of compensation expense for Restricted Stock Awards included in the Company's financial results for the three and nine months ended September 30, 2005.

Stock Unit Awards

The Company may, at its discretion, make awards of stock units under the Plan (Stock Unit Awards) to certain officers and employees. A Stock Unit Award is a grant of a number of hypothetical share units with respect to shares of Common Stock that are subject to vesting and transfer restrictions and conditions under a stock unit award agreement. The value of each unit is equal to the fair market value of one share of Common Stock on any applicable date of determination. The payment with respect to each unit under a Stock Unit Award may be made, at the discretion of the compensation committee of the Board of Directors, in cash or shares of Common Stock or in a combination of both. The grantee of a Stock Unit Award does not have any rights as a stockholder with respect to the shares subject to a Stock Unit Award until such time as shares of Common Stock are delivered to the grantee pursuant to the terms of the related stock unit award agreement.

As provided for in the Plan, the Chief Executive Officer and the Chief Operating Officer (collectively, the Executive Officers) deferred receipt of one-half of their cash performance awards under the Plan for 2005 in exchange for the grant of Stock Unit Awards under the Plan (the Elected Deferral). Upon this election, the Company provided a matching contribution equal to one-half of the amount deferred (the Company Match). The number of stock units subject to such Stock Unit Award is determined by dividing the total amount deferred (including the Company Match) by the fair market value of a share of the Company's Common Stock on the date of payment of the non-deferred portion of the cash performance awards. The Stock Unit Awards vest on the fourth anniversary of the date of grant, subject to the Executive Officer's continued employment with the Company, or any of its subsidiaries, on such vesting date and subject further to accelerated vesting in the event of a change in control of the Company, the Executive Officer's death or disability or the termination of his employment by the Company without cause. The vested Stock Unit Awards are payable in shares of Common Stock upon the earliest to occur of the fifth anniversary of the date of grant, the Executive Officer's death, disability or termination of employment with the Company or a change in control of the Company. In the event that

Table of Contents

an Executive Officer were to terminate employment and stock units resulting from his Elected Deferral remain unvested, the Company would be required to refund to the Executive Officer a cash amount equal to the lesser of such Elected Deferral (less taxes withheld) and the fair market value of such units upon termination of employment. During the nine months ended September 30, 2006, the Company granted 28,518 stock units to the Executive Officers, of which none has been forfeited as of September 30, 2006. During the three and nine months ended September 30, 2005, no Stock Unit Awards were granted. Included in the Company's financial results for the three and nine months ended September 30, 2006 was \$18 thousand and \$41 thousand, respectively, of compensation expense from Stock Unit Awards. Included in the Company's financial results for the three and nine months ended September 30, 2005 was \$10 thousand of compensation expense from Stock Unit Awards.

Stock Option and Restricted Stock Activity

The following table summarizes stock option activity for the nine months ended September 30, 2006, as follows (in thousands, except per share amounts):

Stock Options	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2005	5,490	\$ 7.77		
Granted	565	20.95		
Exercised	(958)	6.43		
Forfeited or expired	(23)	17.51		
Outstanding at September 30, 2006	5,074	\$ 9.45	5.59	\$71,523
Exercisable at September 30, 2006	4,013	\$ 7.60	4.77	\$63,938

The aggregate intrinsic value of stock options in the table above represents total pretax intrinsic value (i.e., the difference between the closing price of the Company's Common Stock on the last trading day of the reporting period and the exercise price, times the number of shares) that would have been received by the option holders had all option holders exercised their options on September 30, 2006. The amount of the aggregate intrinsic value changes, based on the fair market value of the Company's Common Stock. Total intrinsic value of options exercised was \$2.3 million and \$16.4 million for the three and nine months ended September 30, 2006, respectively. Total fair value of options vested during the three and nine months ended September 30, 2006 is \$1.5 million and \$3.4 million, respectively.

As of September 30, 2006, \$4.6 million of total unrecognized compensation costs related to non-vested stock options is expected to be recognized over a weighted average period of 1.7 years.

Table of Contents

The following table summarizes restricted stock activity for the nine months ended September 30, 2006, as follows (in thousands, except per share amounts):

Restricted Stock	Shares	Weighted Average Grant Date Fair Value
Outstanding at December 31, 2005	169	\$ 16.86
Granted	134	21.60
Vested		
Forfeited or expired		
Outstanding at September 30, 2006	303	\$ 18.68

As of September 30, 2006, \$4.2 million of total unrecognized compensation costs related to non-vested Restricted Stock Awards and stock units is expected to be recognized over a weighted average period of 3.1 years.

4. RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 defines fair value as used in numerous accounting pronouncements, establishes a framework for measuring fair value in GAAP and expands disclosures related to the use of fair value measures in financial statements. SFAS No. 157 does not expand the use of fair value measures in financial statements, but standardizes its definition and guidance in GAAP and emphasizes that fair value is a market-based measurement and not an entity-specific measurement based on an exchange transaction in which the entity sells an asset or transfers a liability (exit price). SFAS No. 157 establishes a fair value hierarchy from observable market data as the highest level to fair value based on an entity's own fair value assumptions as the lowest level. SFAS No. 157 is effective for the Company's consolidated financial statements for interim and annual reporting periods beginning after November 15, 2007. The Company is currently evaluating the impact of this new pronouncement on its unaudited condensed consolidated financial statements.

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 provides guidance on the consideration of effects of the prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The SEC staff believes registrants must quantify errors using both a balance sheet and income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 is effective for the first annual period ending after November 15, 2006 with early application encouraged. The Company plans to adopt SAB 108 in its fourth fiscal quarter of 2006. The Company is currently evaluating the impact of SAB 108 on its consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, (FAS No. 48). The interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. Specifically, the pronouncement prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on the related derecognition, classification, interest and penalties, accounting for interim periods, disclosure and transition of uncertain tax positions. FAS No. 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of this new pronouncement on its unaudited condensed consolidated financial statements.

Table of Contents

In March 2006, the Emerging Issues Task Force (EITF) reached a consensus on EITF Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation), (EITF No. 06-3), that entities may adopt a policy of presenting taxes in the income statement either on a gross or net basis. Gross or net presentation may be elected for each different type of tax, but similar taxes should be presented consistently. Taxes within the scope of this EITF would include taxes that are imposed on a revenue transaction between the seller and a customer (e.g., sales taxes, use taxes, value-added taxes, and some types of excise taxes). EITF No. 06-3 is effective for the Company s financial statements for interim and annual reporting periods beginning after December 15, 2006. The Company is currently evaluating the impact of EITF No. 06-3 on its unaudited condensed consolidated financial statements.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS No. 154), which replaces APB Opinion No. 20, Accounting Changes (APB No. 20) and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements (SFAS No. 3). APB No. 20 required that changes in accounting principles be recognized by including the cumulative effect of the change in the period in which the new accounting principle was adopted. SFAS No. 154 requires retrospective application of the change to prior periods financial statements, unless it is impracticable to determine the period-specific effects of the change. SFAS No. 154 also provides that a change in method of depreciating or amortizing a long-lived non-financial asset be accounted for as a change in estimate effected by a change in accounting principle, and also provides that correction of errors in previously issued financial statements should be termed a restatement . SFAS No. 154 is effective for the Company s fiscal year ending December 31, 2006. The adoption of this statement did not have an impact on the Company s unaudited condensed consolidated financial statements.

5. SUBSEQUENT EVENT

In October 2006, the Company acquired 100% of the common stock of RTIX Ltd., a United Kingdom company, and its wholly-owned U.S. subsidiary, RTIX Americas (collectively, RTIX) for a total consideration of \$4.0 million payable in the form of \$3.4 million in cash and \$0.6 million in Common Stock. The Common Stock component of the total consideration is contingent upon RTIX meeting certain financial criteria within a specified timeframe. RTIX developed the performance management/appraisals solution that Ultimate Software has offered its customers since February 2006.

Table of Contents

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

The following discussion of the financial condition and results of operations of The Ultimate Software Group, Inc. (Ultimate Software or the Company) should be read in conjunction with the unaudited Condensed Consolidated Financial Statements and Notes thereto included elsewhere in this Form 10-Q.

Executive Summary

Ultimate Software's UltiPro Workforce Management Software (UltiPro) is a Web-based solution designed to deliver the functionality businesses need to manage the employee life cycle, from compensating and managing benefits to recruiting and hiring to terminating, whether the customers' processes are centralized at headquarters or distributed across multiple divisions or branch offices. The Company's main sources of revenues include sales from the Intersourcing Offering (defined below), sales of perpetual software licenses for UltiPro (and the related annual maintenance) and sales of services (mostly implementation) related to both Intersourcing and license sales.

The Company's primary business strategy was originally centered on sales of perpetual software licenses of UltiPro. In an effort to reduce the volatility and unpredictable nature of a business strategy predominantly focused on license sales, the Company introduced hosting services, branded Intersourcing as an additional revenue source during 2002. Ultimate Software now offers hosting services at two separate data center locations the original location in Miami, Florida, which was opened in 2002, and the location opened in August 2005 in Atlanta, Georgia. With Intersourcing, Ultimate Software provides the hardware, infrastructure, ongoing maintenance and back-up services for its customers at its data centers. Operations of the facilities at both data centers are managed by International Business Machines. Intersourcing is designed to appeal to those customers that want to minimize their internal technology support requirements for the application and hardware.

For the past several years (following the introduction of its Intersourcing offering), the revenue mix in the Company's sales production has favored Intersourcing. Management believes that this trend in sales mix composition will continue to occur in the foreseeable future, with a concentration of unit sales in Intersourcing. Management also believes the shift in sales mix has helped to produce a more predictable revenue stream by providing recurring revenue and cash from Intersourcing over the related contract periods, typically 24 months. As Intersourcing units are sold, the recurring revenue backlog associated with Intersourcing grows, enhancing the predictability of future revenue streams. Intersourcing sales include a one-time upfront fee, priced on a per-employee basis, and ongoing monthly fees, priced on a per-employee-per-month (PEPM) basis. Upfront fees associated with the Intersourcing sale are recognized as recurring subscription revenues ratably over the term of the related contract beginning when the related customer processes its first live payroll (or goes Live). Ongoing monthly PEPM fees are recognized as recurring subscription revenues each month commencing when the related customer goes Live.

In connection with the Company's business strategy, which has a significant focus on Intersourcing sales, an internal financial metric used by the Company in measuring future financial performance is new annual recurring revenues. New annual recurring revenues (ARR) represent the expected one-year value from (i) new Intersourcing sales from the Company's hosted model (including prorated one-time fees); (ii) maintenance revenues related to new license sales; (iii) recurring revenues from new business service providers (BSPs), as well as recurring revenues from new sales by existing BSPs; and (iv) recurring revenues from additional sales to Ultimate Software's existing client base. New annual recurring revenues attributable to sales during the third fiscal quarter of 2006 were \$5.1 million as

Table of Contents

compared to \$4.0 million for the same period in 2005. New annual recurring revenues attributable to sales during the first nine months of 2006 were \$16.5 million as compared to \$11.4 million for the same period of 2005. The main contributors to the increase in new ARR were new Intersourcing sales from the Company's hosted model (including prorated one-time fees) and, to a lesser extent, an increase in annual recurring maintenance revenues related to new license sales.

In addition to Intersourcing, another major component of recurring revenues is subscription revenues generated from the Company's BSP channel. The BSP contributing the most revenues from the BSP channel during each of the three and nine months ended September 30, 2006 and 2005 was Ceridian Corporation (Ceridian) under the Original Ceridian Agreement (defined below). See also Overview Original Ceridian Agreement.

Critical Accounting Policies and Estimates

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

Revenue Recognition

Sources of revenue for the Company include:

Sales of the right to use UltiPro through Intersourcing (the Intersourcing Offering), which includes Hosting Services;

Sales of perpetual licenses for UltiPro in conjunction with services to host the UltiPro application (Hosting Services);

Sales of Hosting Services on a stand-alone basis to customers who already own a perpetual license or are simultaneously acquiring a perpetual license for UltiPro (Base Hosting);

Sales of perpetual licenses for UltiPro;

Recurring revenues derived from (1) maintenance revenues generated from maintaining, supporting and providing periodic updates for the Company's software and (2) subscription revenues generated from PEPM fees earned through the Intersourcing Offering, Base Hosting and the BSP sales channel, amortization of Intersourcing or Hosting Services one-time fees, and revenues generated from the Original Ceridian Agreement; and

Sales of services including implementation, training (also known as knowledge management) and other services, including the provision of payroll-related forms and the printing of Form W-2's for certain customers, as well as services provided to BSPs.

Table of Contents*Sales Generated from the Intersourcing Offering*

Subscription revenues generated from the Intersourcing Offering are recognized in accordance with Emerging Issues Task Force (EITF) No. 00-21, Revenue Arrangements with Multiple Deliverables (EITF No. 00-21) as a services arrangement since the customer is purchasing the right to use UltiPro rather than licensing the software on a perpetual basis. Fair value of multiple elements in Intersourcing arrangements is assigned to each element based on the guidance provided by EITF No. 00-21.

The elements that typically exist in Intersourcing arrangements include hosting services, the right to use UltiPro, maintenance of UltiPro (i.e., product enhancements and customer support) and professional services (i.e., implementation services and training in the use of UltiPro). The pricing for hosting services, the right to use UltiPro and maintenance of UltiPro is bundled (the Bundled Elements). Since these three Bundled Elements are components of recurring revenues in the unaudited condensed consolidated statements of operations, allocation of fair values to each of the three elements is not necessary and they are not reported separately. Fair value for the Bundled Elements, as a whole, is based upon evidence provided by the Company s pricing for Intersourcing arrangements sold separately. The Bundled Elements are provided on an ongoing basis and represent undelivered elements under EITF No. 00-21; they are recognized on a monthly basis as the services are performed, once the customer processes its first live payroll (i.e., goes Live).

Implementation and training services (the Professional Services) provided for Intersourcing arrangements are typically priced on a time and materials basis and are recognized as services revenue in the unaudited condensed consolidated statements of operations as the services are performed. Under EITF 00-21, fair value is assigned to service elements in the arrangement based on their relative fair values, using the prices established when the services are sold on a stand-alone basis. Fair value for Professional Services is based on the respective Implementation Valuation and Training Valuation. If evidence of the fair value of one or more undelivered elements does not exist, the revenue is deferred and recognized when delivery of those elements occurs or when fair value can be established.

The Company believes that applying EITF 00-21 to Intersourcing arrangements as opposed to applying SOP 97-2 is appropriate given the nature of the arrangements whereby the customer has no right to the UltiPro license.

Sales of Base Hosting Services

Subscription revenues generated from Base Hosting are recognized in accordance with EITF No. 00-3, Application of AICPA Statement of Position 97-2 to Arrangements that Include the Right to Use Software Stored on Another Entity s Hardware, which provides guidance as to the application of SOP 97-2 to hosting arrangements that include a license right to the software. The elements that typically exist for Base Hosting arrangements include hosting services and implementation services. Base Hosting is different than Intersourcing arrangements in that the customer already owns a perpetual license or is purchasing a perpetual license for UltiPro and is purchasing hosting services subsequently in a separate transaction, whereas with Intersourcing the customer is purchasing the right to use (not license) UltiPro. Implementation services provided for Base Hosting arrangements are substantially less than those provided for Intersourcing arrangements since UltiPro is already implemented in Base Hosting arrangements and only needs to be transitioned to a hosted environment. Fair value for hosting services is based on the Hosting Valuation. The fair value for implementation services is based on the Implementation Valuation in accordance with guidelines provided by SOP 97-2.

Table of Contents*Perpetual Licenses for UltiPro Sold With or Without Hosting Services*

Sales of perpetual licenses for UltiPro and sales of perpetual licenses for UltiPro in conjunction with Hosting Services are multiple-element arrangements that involve the sale of software and consequently fall under the guidance of Statement of Position (SOP) 97-2, Software Revenue Recognition, for revenue recognition.

The Company licenses software under non-cancelable license agreements and provides services including maintenance, implementation consulting and training services. In accordance with the provisions of SOP 97-2, license revenues are generally recognized when (1) a non-cancelable license agreement has been signed by both parties, (2) the product has been shipped, (3) no significant vendor obligations remain and (4) collection of the related receivable is considered probable. To the extent any one of these four criteria is not satisfied, license revenue is deferred and not recognized in the unaudited condensed consolidated statements of operations until all such criteria are met.

For multiple-element software arrangements, each element of the arrangement is analyzed and the Company allocates a portion of the total fee under the arrangement to the elements based on vendor-specific objective evidence of fair value of the element (VSOE), regardless of any separate prices stated within the contract for each element. Fair value is considered the price a customer would be required to pay when the element is sold separately.

The Residual Method (as defined below) is used to recognize revenue when a license agreement includes one or more elements to be delivered at a future date and VSOE of the fair value of all undelivered elements exists. The fair value of the undelivered elements is determined based on the historical evidence of stand-alone sales of these elements to customers. Undelivered elements in a license arrangement typically include maintenance, implementation and training services (the Standard Undelivered Elements). The fair value for maintenance fees is based on the price of the services sold separately, which is determined by the annual renewal rate historically and consistently charged to customers (the Maintenance Valuation). Maintenance fees are generally priced as a percentage of the related license fee. The fair value for implementation services is based on standard pricing (i.e., rate per hour charged to customers for implementation services), for stand-alone sales of implementation services (the Implementation Valuation). The fair value for training services is based on standard pricing (i.e., rate per training day charged to customers for class attendance), taking into consideration stand-alone sales of training services through year-end seminars and historically consistent pricing for such services (the Training Valuation). Under the residual method (the Residual Method), the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee attributable to the delivered element, the license fee, is recognized as license revenue. If VSOE for one or more undelivered elements does not exist, the revenue is deferred on the entire arrangement until the earlier of the point at which (i) such VSOE does exist or (ii) all elements of the arrangement have been delivered.

Perpetual licenses of UltiPro sold without Hosting Services typically include a license fee and the Standard Undelivered Elements. Fair value for the Standard Undelivered Elements is based on the Maintenance Valuation, the Implementation Valuation and the Training Valuation. The delivered element of the arrangement, the license fee, is accounted for in accordance with the Residual Method.

Perpetual licenses of UltiPro sold with Hosting Services typically include a license fee, the Standard Undelivered Elements and Hosting Services. Fair value for the Standard Undelivered Elements is based on the Maintenance Valuation, the Training Valuation and the Implementation Valuation. Hosting Services are delivered to customers on a PEPM basis over the term of the related customer contract (Hosting PEPM Services). Upfront fees charged to customers represent fees for the hosting infrastructure, including hardware costs, third-party license fees and other upfront costs incurred by the Company in relation to

Table of Contents

providing such services (Hosting Upfront Fees). Hosting PEPM Services and Hosting Upfront Fees (collectively, Hosting Services) represent undelivered elements in the arrangement since their delivery is over the course of the related contract term. The fair value for Hosting Services is based on standard pricing (i.e., rate charged PEPM), taking into consideration stand-alone sales of Hosting Services through the sale of such services to existing customers (i.e., those who already own the UltiPro perpetual license at the time Hosting Services are sold to them) and historically consistent pricing for such services (the Hosting Valuation). The delivered element of the arrangement, the license fee, is accounted for in accordance with the Residual Method.

The Company's customer contracts are non-cancelable agreements. The Company does not provide for rights of return or price protection on its software. The Company provides a limited warranty that its software will perform in accordance with user manuals for varying periods, which are generally less than one year from the contract date. The Company's customer contracts generally do not include conditions of acceptance. However, if conditions of acceptance are included in a contract or uncertainty exists about customer acceptance of the software, license revenue is deferred until acceptance occurs.

Recurring Revenues

Recurring revenues include maintenance revenues and subscription revenues. Maintenance revenues are derived from maintaining, supporting and providing periodic updates for the Company's software. Subscription revenues are principally derived from PEPM fees earned through the Intersourcing Offering, Base Hosting and the BSP sales channel, as well as revenues generated from the Original Ceridian Agreement. Maintenance revenues are recognized ratably over the service period, generally one year. Maintenance and support fees are generally priced as a percentage of the initial license fee for the underlying products.

To the extent there are upfront fees associated with the Intersourcing Offering, Base Hosting or the BSP sales channel, subscription revenues are recognized ratably over the minimum term of the related contract upon the delivery of the product and services. In the cases of Intersourcing and Base Hosting sales, amortization of the upfront fees commences when the customer processes its first Live payroll, which typically occurs four to six months after the sale, and extends until the end of the initial contract period. In the case of BSP channel sales, amortization of the upfront fee typically commences when the contract is signed, which is when the BSP's rights under the agreement begin, continuing until the initial contract term ends. Ongoing PEPM fees from the Intersourcing Offering, Base Hosting and the BSP sales channel are recognized as subscription revenue as the services are delivered, typically on a monthly basis.

Commencing on August 28, 2002, subscription revenues generated from the Original Ceridian Agreement are recognized ratably over the minimum term of the contract, which extends until March 9, 2008 (7 years from the effective date of the Original Ceridian Agreement). Subscription revenues of \$642,000 per month are based on guaranteed minimum payments from Ceridian of approximately \$42.7 million over the minimum contract term, including \$33.3 million received to date. The amount of subscription revenue recognized under the Original Ceridian Agreement during the three and nine months ended September 30, 2006, totaling \$1.9 million and \$5.8 million, respectively, was the same as that recognized in the same periods of 2005. The Company expects to continue to recognize \$642,000 per month (or \$7.7 million per annum) as recurring subscription revenue until March 9, 2008 when the Original Ceridian Agreement terminates.

Maintenance services provided to customers include product updates and technical support services. Product updates are included in general releases to the Company's customers and are distributed on a periodic basis. Such updates may include, but are not limited to, product enhancements, payroll tax updates, additional security features or bug fixes. All features provided in general releases are unspecified

Table of Contents

upgrade rights. To the extent specified upgrade rights or entitlements to future products are included in a multi-element arrangement, revenue is recognized upon delivery provided fair value for the elements exists. In multi-element arrangements that include a specified upgrade right or entitlement to a future product, if fair value does not exist for all undelivered elements, revenue for the entire arrangement is deferred until all elements are delivered or when fair value can be established.

Subscription revenues generated from the BSP sales channel include both the right to use UltiPro and maintenance. The BSP is charged a fee on a PEPM basis and, in several cases, is subject to a guaranteed monthly minimum amount for the term of the related agreement. Revenue is recognized on a PEPM basis. To the extent the BSP pays the Company a one-time upfront fee, the Company accounts for such fee by recognizing it as subscription revenue over the minimum term of the related agreement.

Services, including Implementation and Training Services

Services revenues include revenues from fees charged for the implementation of the Company's software products and training of customers in the use of such products, fees for other services, including services provided to BSPs, the provision of payroll-related forms and the printing of Form W-2's for certain customers, as well as certain reimbursable out-of-pocket expenses. Revenues for implementation consulting and training services are recognized as services are performed to the extent the pricing for such services is on a time and materials basis and the payment terms are within the Company's ordinary and customary payment cycle. In the event payments for services are outside the ordinary and customary period for the Company, the related revenues are recognized as payments come due based on their relative fair values. Other services are recognized as the product is shipped or as the services are rendered depending on the specific terms of the arrangement.

Arrangement fees related to fixed-fee implementation services contracts are recognized using the percentage of completion accounting method, which involves the use of estimates. Percentage of completion is measured at each reporting date based on hours incurred to date compared to total estimated hours to complete. If a sufficient basis to measure the progress towards completion does not exist, revenue is recognized when the project is completed or when the Company receives final acceptance from the customer.

The Company recognizes revenue in accordance with the Securities Exchange Commission (SEC) Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements (SAB No. 101) and the SEC Staff Accounting Bulletin No. 104, Revenue Recognition (SAB No. 104). Management believes the Company is currently in compliance in all material aspects with the current provisions set forth in SOP 97-2, SOP 98-9, EITF 00-21, EITF 00-3, SAB No. 101 and SAB No. 104.

Allowance for Doubtful Accounts

The Company maintains an allowance for doubtful accounts at an amount estimated to be sufficient to provide adequate protection against losses resulting from collecting less than full payment on accounts receivable. In assessing the adequacy of the allowance for doubtful accounts, the Company considers multiple factors including historical bad debt experience, the general economic environment, and the aging of its receivables. A considerable amount of judgment is required when the realization of receivables is assessed, including assessing the probability of collection and current credit-worthiness of each customer. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of their ability to make payments, an additional provision for doubtful accounts may be required.

Table of Contents**Deferred Taxes**

The Company provides a valuation allowance for that portion of deferred tax assets which is not likely to be recognized due to the Company's cumulative losses and the uncertainty as to future recoverability. Any reversal of the deferred tax valuation allowance is made when the Company believes that it is more likely than not that this portion of the deferred tax asset will be realized. The computation of the deferred tax assets and related valuation allowance is based on taxable income expected to be earned over future periods which will include the utilization of previously accumulated net operating tax losses. Each quarter, the Company will continue to evaluate the amount, if any, of additional reduction or increase of the valuation allowance that should be made. This will be based on management's estimate and conclusions regarding the ultimate realization of the deferred tax assets, including but not limited to the Company's recent financial results as well as projected earnings over future periods. While the Company has considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the deferred tax valuation allowance, in the event the Company is able to determine that it would be able to realize the deferred tax assets in the future, a reduction in the deferred tax asset valuation allowance would increase income in the period the determination was made.

Overview

Ultimate Software designs, markets, implements and supports payroll and workforce management solutions.

Ultimate Software's UltiPro Workforce Management Software (UltiPro) is a Web-based solution designed to deliver the functionality businesses need to manage the employee life cycle, from compensating and managing benefits to recruiting and hiring to terminating, whether the customers' processes are centralized at headquarters or distributed across multiple divisions or branch offices. UltiPro's human resources (HR) and benefits management functionality is wholly integrated with a flexible payroll engine, reporting and analytical decision-making tools, and a self-service Web portal for executives, managers, administrators, and employees to review and update work-related and personal information. Ultimate Software believes that UltiPro helps customers streamline HR and payroll processes to significantly reduce administrative and operational costs, while also empowering executives and staff to access critical information quickly and perform routine business activities efficiently.

UltiPro is marketed both through the Company's direct sales team as well as through alliances with business service providers (BSPs) that market co-branded UltiPro to their customer bases. Ultimate Software's direct sales team focuses primarily on companies with more than 500 employees and sells both a license model (typically in-house) and a service model (typically hosted and priced on a PEPM basis). The Company's BSP alliances focus primarily on companies with under 500 employees and, since 2004, very large companies, generally those with over 10,000 employees, as well. The Company's BSP alliances typically sell an Internet solution, which includes UltiPro, priced on a monthly/service basis. When the BSP sells its Internet solution, incorporating UltiPro in the offering, the BSP is obligated to remit a fee to the Company, typically measured on a PEPM basis and, in some cases, subject to a guaranteed monthly minimum amount.

The Company's direct sales force markets UltiPro as an in-house human resources, payroll and workforce management solution and alternatively as a hosted offering branded Intersourcing (the Intersourcing Offering). Intersourcing provides Web access to comprehensive workforce management functionality for organizations that need to simplify the information technology (IT) support requirements of their business applications. Ultimate Software believes that Intersourcing is attractive to companies that want to focus on their core competencies to increase sales and profits. Through the Intersourcing model, introduced in 2002, the Company provides the hardware, infrastructure, ongoing

Table of Contents

maintenance and backup services for its customers at two data centers located in Miami, Florida and Atlanta, Georgia (opened in August 2005), both managed by IBM.

Intersourcing Offering

In 2002, the Company began offering a hosting service, branded Intersourcing, whereby the Company provides the hardware, infrastructure, ongoing maintenance and back-up services for its customers at a data center located in Miami, Florida, which is managed by IBM. In August 2005, the Company opened a second data center, which is located in Atlanta, Georgia and is also managed by IBM. Different types of hosting arrangements include the sale of Hosting Services as a part of the Intersourcing Offering, discussed below, and, to a lesser extent, the sale of Hosting Services to customers that license UltiPro on a perpetual basis. Hosting Services, typically available in a shared environment, provide Web access to comprehensive workforce management functionality for organizations that need to simplify the IT support requirements of their business applications and are priced on a PEPM basis. In the shared environment, Ultimate Software provides an infrastructure with applicable servers shared among many customers who use a Web browser to access the application software through the data centers.

The Intersourcing Offering is designed to provide an appealing pricing structure to customers who prefer to minimize the initial cash outlay associated with typical capital expenditures. Intersourcing customers purchase the right to use UltiPro on an ongoing basis for a specific term, typically in a shared environment. The pricing for Intersourcing, including both the hosting element as well as the right to use UltiPro, is on a PEPM basis.

Original Ceridian Agreement

During 2001, Ultimate Software and Ceridian reached an agreement, as amended in 2002, which granted Ceridian a non-exclusive license to use UltiPro software as part of an on-line offering that Ceridian can market primarily to businesses with under 500 employees (the Original Ceridian Agreement). Ceridian marketed that solution under the name SourceWeb.

Under the agreement, Ceridian is required to pay the Company a monthly license fee based on the number of employees paid using the licensed software. These payments are subject to a minimum monthly payment of \$500,000 per month with increases of 5% per annum, compounded beginning in January 2006. The aggregate minimum payments that Ceridian is obligated to pay Ultimate Software under the Original Ceridian Agreement over the minimum term of the Agreement are \$42.7 million. To date, Ceridian has paid to Ultimate Software a total of \$33.3 million under the Original Ceridian Agreement.

Effective March 9, 2006, Ceridian provided Ultimate Software with a two years advance written notice of termination of the Original Ceridian Agreement, as permitted under the terms of the Agreement. Pursuant to such notice, the Original Ceridian Agreement will terminate on March 9, 2008 (unless terminated earlier for an uncured material breach).

During December 2004, RSM McGladrey Employer Services (RSM), an existing BSP of Ultimate Software, acquired Ceridian's SourceWeb HR/payroll and self-service product and existing SourceWeb base of small and midsize business customers throughout the United States (the RSM Acquisition). The financial terms of the Original Ceridian Agreement have not changed as a result of the RSM Acquisition. Ceridian continues to be financially obligated to pay Ultimate Software a minimum fee of \$500,000 per month with increases of 5% per annum, compounded beginning in January 2006. Therefore, the minimum monthly fee payable to Ultimate Software from Ceridian in 2006 is \$525,000.

Table of Contents

Ultimate Software expects to continue to recognize a minimum of \$642,000 per month, or \$7.7 million per year, in recurring subscription revenues from the Original Ceridian Agreement until its termination on March 9, 2008.

Items Affecting Comparability between Periods

Prior to January 1, 2006, the Company accounted for share-based plans under the recognition and measurement requirements of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations, as permitted by Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation. Prior to January 1, 2006, stock-based compensation expense was recognized only for grants of restricted stock awards, stock units and stock options which were granted at exercise prices less than the fair market value of the underlying Common Stock on the grant date. During the three and nine months ended September 30, 2005, while there were no grants of stock units, there were grants of restricted stock awards. In addition, stock options that had exercise prices less than the fair market value of the Common Stock on the grant date were granted to certain members of the Board of Directors for Board Services and fully vested on the grant date. Therefore, stock-based compensation expense for the three and nine months ended September 30, 2005 is related to both restricted stock awards granted and the options granted to certain members of the Board for Board Services, recorded in accordance with APB No. 25.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123R,

Share-Based Payment, using the modified-prospective transition method. Under this transition method, compensation was recognized beginning January 1, 2006 and includes (a) compensation expense for all share-based employee compensation arrangements granted prior to, but not yet vested as of, January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation expense for all share-based employee compensation arrangements granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R. Results of prior periods have not been restated.

The following table sets forth the stock-based compensation expense (SBC) resulting from share-based arrangements that is recorded in the Company's unaudited condensed consolidated statements of operations for the periods indicated (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
Cost of recurring revenues	\$ 89	\$	\$ 289	\$
Cost of service revenues	157		605	
Cost of license revenues	1		5	
Sales and marketing	788	32	2,035	44
Research and development	117		413	
General and administrative	263	\$ 39	781	\$ 112
Total SBC	\$ 1,415	\$ 71	\$ 4,128	\$ 156

As of September 30, 2006, \$4.6 million of total unrecognized compensation costs related to non-vested stock options is expected to be recognized over a weighted average period of 1.7 years. As of September 30, 2006, \$4.2 million of total unrecognized compensation costs related to non-vested restricted stock awards and stock units is expected to be recognized over a weighted average period of 3.1 years.

Table of Contents

Included in capitalized software on the Company's unaudited condensed consolidated balance sheet at September 30, 2006 was \$30 thousand in stock-based compensation incurred in the development of UltiPro Canada during the first nine months of 2006. This amount would otherwise have been charged to research and development expense for the nine months ended September 30, 2006.

Results of Operations

The following table sets forth the unaudited condensed consolidated statements of operations data of the Company, as a percentage of total revenues, for the periods indicated.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenues:				
Recurring	57.3%	58.4%	56.8%	57.6%
Services	32.7	29.2	31.8	30.0
License	10.0	12.4	11.4	12.4
Total revenues	100.0	100.0	100.0	100.0
Cost of revenues:				
Recurring	16.0	16.2	15.9	15.8
Services	25.3	23.3	25.2	23.5
License	1.1	0.7	1.2	0.7
Total cost of revenues	42.4	40.2	42.3	40.0
Operating expenses:				
Sales and marketing	25.1	24.9	26.6	25.1
Research and development	20.4	23.7	20.2	23.9
General and administrative	8.8	8.8	9.2	9.0
Total operating expenses	54.3	57.4	56.0	58.0
Operating income (loss)	3.3	2.4	1.7	2.0
Interest expense	(0.2)	(0.2)	(0.2)	(0.3)
Interest and other income	1.4	1.0	1.4	0.8
Net income (loss)	4.5%	3.2%	2.9%	2.5%

Revenues

The Company's revenues are derived from three principal sources: recurring revenues, services revenues and software licenses (license revenues).

Recurring revenues include annual maintenance on software license agreements for the Company's products and subscription revenues. Maintenance revenues are derived from maintaining, supporting and providing periodic updates for the Company's software. Subscription revenues are principally derived from fees earned through the Intersourcing Offering, Base Hosting and the BSP sales channel, as well as revenues generated from the Original Ceridian Agreement. Maintenance revenues are recognized ratably over the service period, generally one year. To the extent there are upfront fees associated with the Intersourcing Offering, Base Hosting or the BSP sales channel,

subscription revenues are recognized ratably over the term of the related contract upon the delivery of the product and services. Per-employee-per-month (PEPM) fees from the Intersourcing Offering, Base Hosting and the BSP sales channel are recognized as subscription revenues as the services are delivered. All of the Company's customers that purchased software during the three and nine months ended September, 2006 and 2005 also purchased maintenance and support service contracts. Maintenance and support fees are generally priced as a percentage of the initial license fee for the underlying products.

Table of Contents

Services revenues include revenues from fees charged for the implementation of the Company's software products and training of customers in the use of such products, fees for services provided to BSPs, the provision of payroll-related forms and the printing of Form W-2's for certain customers and certain reimbursable out-of-pocket expenses. Revenues for training and implementation consulting services are recognized as services are performed to the extent the pricing for such services is either on a time and materials basis or the payment terms are within the Company's ordinary and customary payment cycle. In the event payments for services are outside the ordinary and customary period for the Company, the related revenues are recognized as payments come due based on their relative fair values. Other services are recognized as the product is shipped or as the services are rendered.

License revenues include revenues from software license agreements for the Company's products, entered into between the Company and its customers in which the license fees are non-cancelable. License revenues are generally recognized upon the delivery of the related software product when all significant contractual obligations have been satisfied. Until such delivery, the Company records amounts received when contracts are signed as customer deposits which are included with deferred revenues in the unaudited consolidated balance sheets.

Total revenues, consisting of recurring, services and license revenues, increased 29.7% to \$28.8 million for the three months ended September 30, 2006 and by 28.5% to \$81.8 million for the nine months ended September 30, 2006.

Recurring revenues increased 27.3% to \$16.5 million for the three months ended September 30, 2006 and 26.6% to \$46.5 million for the nine months ended September 30, 2006. The increases in recurring revenues for the three and nine months ended September 30, 2006 were primarily due to increases in Intersourcing revenues, maintenance revenues, and, to a lesser extent, subscription revenues. Intersourcing revenues increased due to incremental recurring subscription revenues generated from additional previously sold Intersourcing units which went live (i.e., when the underlying customer processes its first live payroll for its employees) since September 30, 2005. Recognition of recurring subscription revenues for Intersourcing unit sales commences upon live date. Maintenance revenues increased due to additional maintenance fees resulting from cumulative increases in the customer base subsequent to September 30, 2005 due to incremental license sales since such date. Maintenance revenues are recognized over the initial term of the related license contract, which is typically 12 months, and then on a recurring basis thereafter (on a monthly basis ratably over the term of the respective renewal period).

Services revenues increased 45.1% to \$9.4 million for the three months ended September 30, 2006 and 36.3% to \$26.0 million for the nine months ended September 30, 2006. The increases in the three- and nine- month periods were mainly due to increases in implementation revenues primarily due to additional billable hours stemming from a combination of implementing incremental units sold and an increase in the number of the Company's revenue-generating consultants and a higher rate per hour. In addition, the Company used third-party implementation partners significantly more in 2006 (with a concentrated use in the third quarter) to assist in handling the increased demand for implementations due to increased sales, which contributed to the growth in services revenues.

License revenues increased 5.0% to \$2.9 million for the three months ended September 30, 2006 and 18.1% to \$9.3 million for the nine months ended September 30, 2006. The marginal increase in the three month period was principally due to a higher average selling price per unit for UltiPro, as well as additional license sales of add-on products (i.e., products sold with UltiPro, which have an incremental fee), including UltiPro time and attendance (UTA) and Recruitment. The increase in the nine month period was primarily due to the sale of one larger than average license unit sold during the first quarter of 2006 and a higher average selling price per unit (excluding the impact of the large sale in early 2006).

Table of Contents*Cost of Revenues*

Cost of revenues consists of the cost of recurring, services and license revenues. Cost of recurring revenues consists of costs to provide maintenance and technical support to the Company's customers, the cost of providing periodic updates and the cost of subscription revenues, including, to a lesser extent, amortization of certain capitalized software. Cost of services revenues primarily consists of costs to provide implementation services and training to the Company's customers and costs to provide services to BSP's and, to a lesser degree, costs related to sales of payroll-related forms and costs associated with certain reimbursable out-of-pocket expenses. Cost of license revenues primarily consists of fees payable to third-parties for software products distributed by the Company. UltiPro includes third-party software for enhanced report-writing purposes, and, to a lesser extent, certain product initiatives, such as employee recruitment and time and attendance. When UltiPro licenses are sold, customers pay the Company on a per user basis for the license rights to the third-party software.

Total cost of revenues (including \$0.2 million in stock-based compensation for the three months ended September 30, 2006) increased 36.8% to \$12.2 million for the three months ended September 30, 2006. Total cost of revenues (including \$0.9 million in stock-based compensation for the nine months ended September 30, 2006) increased 36.0% to \$34.7 million for the nine months ended September 30, 2006

Cost of recurring revenues increased 28.3% to \$4.6 million for the three months ended September 30, 2006 and by 30.1% to \$13.0 million for the nine months ended September 30, 2006. The increases in cost of recurring revenues for the three and nine months ended September 30, 2006 (which included stock-based compensation of \$0.1 million and \$0.3 million for the three and nine months ended September 30, 2006, respectively), was primarily due to the increases in both Intersourcing costs and maintenance costs. The increase in the Intersourcing costs was principally due to the growth in Intersourcing operations and increased sales, including increased labor costs and higher operating costs such as depreciation and amortization of related computer equipment supporting the operations and costs associated with the operations of the Company's two data centers, including the impact of opening the second data center in August 2005. The increase in maintenance costs was primarily related to increased labor costs commensurate with the growth in the number of customers serviced.

Cost of services revenues increased 41.0% to \$7.3 million for the three months ended September 30, 2006 and by 37.8% to \$20.7 million for the nine months ended September 30, 2006. The increase in cost of services revenues for the three and nine month periods ended September 30, 2006 (which included stock-based compensation of \$0.2 million and \$0.6 million for the three and nine months ended September 30, 2006, respectively), was primarily due to an increase in costs of implementation. Due to the continued sales growth of both Intersourcing and license units, there was an increase in labor costs primarily resulting from additional billable consultants hired to support this growth and, to a lesser extent, the use of third-party implementation partners who assisted in handling the increased demand for implementing UltiPro and add-on products.

Cost of license revenues increased 93.3% to \$319,000 for the three months ended September 30, 2006 and by 108.2% to \$966,000 for the nine months ended September 30, 2006. The increase in cost of license revenues for the three and nine months ended September 30, 2006 was principally due to higher royalties paid to third-party vendors for products sold in conjunction with UltiPro, including new add-on products such as UTA.

Table of Contents*Sales and Marketing*

Sales and marketing expenses consist primarily of personnel costs, including sales commissions, as well as travel and promotional expenses, facility and communication costs for direct sales offices and advertising and marketing costs. Sales and marketing expenses increased 30.8% to \$7.2 million for the three months ended September 30, 2006 and by 35.9% to \$21.7 million for the nine months ended September 30, 2006. The \$1.7 million increase in the three-month period ended September 30, 2006 and the \$5.7 million increase in the nine-month period ended September 30, 2006 were principally due to increased sales commissions and other additional labor costs (including \$0.8 million and \$2.0 million of stock-based compensation for the three- and nine- month periods ended September 30, 2006, respectively), partly attributable to hiring additional personnel for the sales organization associated with the new UltiPro add-on product offerings, such as UTA, as well as expected sales of UltiPro Canada (defined below), once developed. Sales commissions increased on both license revenues as well as Intersourcing revenues, correlating with the growth in those revenue sources. Sales commissions on license sales are recognized when the license revenues are recognized, which is typically when the product is shipped. Sales commissions on Intersourcing sales are amortized over the initial contract term (typically 24 months) commencing on live date, which corresponds to Intersourcing revenue recognition. Increased sales commissions also resulted from a higher percentage of sales being made by salespeople in the direct sales force whose year-to-date performance placed them at higher commission rates.

Research and Development

Research and development expenses consist primarily of software development personnel costs. Research and development expenses increased 12.1% to \$5.9 million three months ended September 30, 2006 and by 8.5% to \$16.5 million for the nine months ended September 30, 2006. Excluding the impact of capitalized costs associated with UltiPro Canada, which totaled \$0.5 million and \$1.3 million for the three- and nine-month periods ended September 30, 2006, research and development expenses increased \$1.1 million and \$2.5 million, respectively, in 2006, in comparison to the same periods last year, principally due to higher labor costs, including the impact of increased staffing needs related to the ongoing development of UltiPro Canada, increased development for UltiPro, including product enhancements and additional functionality, as well as annual merit increases and, to a lesser extent, \$0.1 million and \$0.4 million of stock-based compensation expense for the three and nine month periods ended September 30, 2006, respectively.

In accordance with SFAS No. 86, Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed, the Company capitalized certain research and development personnel costs for the development of UltiPro Canadian HR/payroll (UltiPro Canada) functionality. UltiPro Canada is being built from the existing product infrastructure of UltiPro (e.g., using UltiPro s source code and architecture). UltiPro Canada will provide HR/payroll functionality which includes the availability of Canadian tax rules, as well as Canadian human resources functionality, taking into consideration labor laws in Canada and including changes to the language where necessary (i.e., English to French). The Company expects to capitalize additional research and development costs relative to the UltiPro Canada project during the remainder of 2006 and the first half of 2007 as it anticipates a general release of UltiPro Canada approximately toward the end of the first half of 2007, at which time capitalization would cease under SFAS No. 86 guidelines.

General and Administrative

General and administrative expenses consist primarily of labor costs for executive, administrative and financial personnel, as well as external professional fees and the provision for doubtful accounts. General and administrative expenses for the three months ended September 30, 2006 increased 29.9% to \$2.5 million and by 32.0% to \$7.5 million for the nine months ended September 30, 2006. The increase

Table of Contents

for the three months ended September 30, 2006 was primarily due to an increase in the provision for doubtful accounts attributable to the growth in accounts receivable (commensurate with sales growth), an increase in external professional fees and additional labor costs (including additional personnel to support the Company's growth). The increase for the nine-month period ended September 30, 2006 was primarily due to increased labor costs attributable to hiring additional personnel to support the Company's growth and, to a lesser extent, annual merit increases. Included in general and administrative expenses for the three and nine month periods ended September 30, 2006 was \$0.3 million and \$0.8 million, respectively, of stock-based compensation expense.

Interest Expense

Interest expense of \$0.1 million and \$0.2 million for the three and nine month periods ended September 30, 2006, respectively, was comparable to interest expense during the same periods in the prior year.

Interest and Other Income

Interest and other income increased 87.9% to \$419 thousand for the three months ended September 30, 2006 and 118.3% to \$1.1 million for the nine months ended September 30, 2006. The increases in interest and other income for the three and nine month ended September 30, 2006 were primarily due to interest income on increased cash and cash equivalents available for investment, excluding investments in marketable securities available for sale. See Note 2 to the unaudited condensed consolidated financial statements included herein for further discussion on investments in marketable securities available for sale.

Income Taxes

No provision or benefit for federal, state or foreign income taxes was made for the three months ended September 30, 2006 or 2005 due to the operating loss carryforwards from prior periods incurred in the respective periods. Net operating loss carryforwards available at December 31, 2005 which expire at various times through the year 2025 are available to offset future taxable income were \$67.0 million. The timing and levels of future profitability may result in the expiration of net operating loss carryforwards before utilization. Additionally, utilization of such net operating losses may be limited as a result of cumulative ownership changes in the Company's equity instruments.

Liquidity and Capital Resources

The Company has historically funded operations primarily through the private and public sale of equity securities and, to a lesser extent, equipment financing and borrowing arrangements.

As of September 30, 2006, the Company had \$31.9 million in cash, cash equivalents and total investments in marketable securities, reflecting a net decrease of \$0.9 million since December 31, 2005. This decrease was primarily due to repurchases of Common Stock of \$9.8 million, an increase in capital expenditures of \$6.3 million (including cash purchases of property and equipment and principal payments on financed equipment from capital lease obligations and principal payments on the Equipment Loan, defined below) and additional capitalized software of \$1.3 million, partially offset by cash generated from operations of \$10.3 million and cash proceeds from employee stock option exercises of \$6.2 million.

Net cash provided by operating activities was \$10.3 million for the nine months ended September 30, 2006 as compared to \$2.6 million for the nine months ended September 30, 2005. The \$7.7 million

Table of Contents

increase in net cash provided by operating activities was primarily due to an increase in funds generated from operations related to the Company's sales growth, including sales of Intersourcing units.

Net cash used in investing activities was \$8.5 million for the nine months ended September 30, 2006 as compared to \$3.0 million for the nine months ended September 30, 2005. The \$5.5 million increase in net cash used in investing activities was primarily due to increased cash purchases of property and equipment of \$2.3 million, an increase in net purchases of marketable securities of \$2.0 million and an increase in capitalized software costs associated with UltiPro Canada of \$1.3 million.

Net cash used in financing activities was \$5.2 million for the nine months ended September 30, 2006 as compared to net cash provided by financing activities of \$3.9 million for the nine months ended September 30, 2005. The \$9.1 million decrease in net cash used in financing activities was primarily related to Company repurchases of Common Stock of \$9.8 million (whereas no such repurchases were made in the prior year comparable period) as well as an increase in principal payments on financed equipment of \$1.0 million, partially offset by an increase in net proceeds from exercises of employee stock options of \$1.7 million.

Days sales outstanding, calculated on a trailing three-month basis (DSO), as of September 30, 2006 and 2005, were 66 days and 58 days, respectively. The increase in DSO's as of September 30, 2006 was related to the increase in accounts receivable principally from incremental revenues generated.

Deferred revenues were \$37.2 million at September 30, 2006 as compared to \$33.0 million at December 31, 2005. The increase of \$4.2 million in deferred revenues for 2006 was primarily due to increased sales from Intersourcing operations (which originate deferred revenues upon contract execution for the upfront fees and initial PEPM fees). Substantially all of the total balance in deferred revenues is related to future recurring revenues, including Intersourcing.

The Company had a credit facility (the Credit Facility) with Silicon Valley Bank, which was secured by the Company's eligible accounts receivable. The Credit Facility was comprised of a revolving line of credit (the Revolver) and an equipment term loan (the Equipment Loan). The Credit Facility's Revolver expired on May 27, 2006. Based upon the strength and consistency of the cash flow position as well as management's expectations for the next twelve months, the Company chose not to renew the Credit Facility upon its expiration. The Credit Facility's Equipment Loan, while still effective, did not have any future borrowing capacity after May 27, 2006. The outstanding balance of \$0.8 million under the Equipment Loan as of September 30, 2006 is payable on or before December 31, 2008 under the payment terms of such agreement. As of September 30, 2006, the Company was in compliance with all covenants included in the terms of the Credit Facility.

In October 2006, the Company acquired 100% of the common stock of RTIX Ltd., a United Kingdom company, and its wholly-owned U.S. subsidiary, RTIX Americas (collectively, RTIX) for a total consideration of \$4.0 million payable in the form of \$3.4 million in cash and \$0.6 million in Common Stock. The Common Stock component of the total consideration is contingent upon RTIX meeting certain financial criteria within a specified timeframe. RTIX developed the performance management/appraisals solution that Ultimate Software has offered its customers since February 2006.

During August 2006, the Company formed a wholly-owned subsidiary, The Ultimate Software Group of Canada, Inc. (the Canadian Subsidiary). The Canadian Subsidiary is expected to accommodate the Company's future sales operations in Canada, primarily related to UltiPro Canada, which is currently under development.

Table of Contents

The Company believes that cash and cash equivalents, investments in marketable securities and cash generated from operations will be sufficient to fund its operations for at least the next 12 months. This belief is based upon, among other factors, management's expectations for future revenue growth, controlled expenses and collections of accounts receivable.

Off-Balance Sheet Arrangements

The Company does not have any off-balance sheet arrangements (as that term is defined in applicable SEC rules) that are reasonably likely to have a current or future material effect on the Company's financial condition, results of operations, liquidity, capital expenditures or capital resources.

Quarterly Fluctuations

The Company's quarterly revenues and operating results have varied significantly in the past and are likely to vary substantially from quarter to quarter in the future. The Company's operating results may fluctuate as a result of a number of factors, including, but not limited to, increased expenses (especially as they relate to product development and sales and marketing), timing of product releases, increased competition, variations in the mix of revenues, announcements of new products by the Company or its competitors and capital spending patterns of the Company's customers. The Company establishes its expenditure levels based upon its expectations as to future revenues, and, if revenue levels are below expectations, expenses can be disproportionately high. A drop in near term demand for the Company's products could significantly affect both revenues and profits in any quarter. Operating results achieved in previous fiscal quarters are not necessarily indicative of operating results for the full fiscal years or for any future periods. As a result of these factors, there can be no assurance that the Company will be able to maintain profitability on a quarterly basis. The Company believes that, due to the underlying factors for quarterly fluctuations, period-to-period comparisons of its operations are not necessarily meaningful and that such comparisons should not be relied upon as indications of future performance.

Forward-Looking Statements

The foregoing Management's Discussion and Analysis of Financial Condition and Results of Operations contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). These forward-looking statements represent the Company's expectations or beliefs, including, but not limited to, statements concerning the Company's operations and financial performance and condition. Words such as anticipates, expects, intends, plans, believes, seeks, estimates, and similar expressions are intended to identify such forward-looking statements. These forward-looking statements are not guarantees of future performance and are subject to certain risks and uncertainties that are difficult to predict. The Company's actual results could differ materially from those contained in the forward-looking statements due to risks and uncertainties associated with fluctuations in the Company's quarterly operating results, concentration of the Company's product offerings, development risks involved with new products and technologies, competition, the Company's relationships with third parties, contract renewals with business partners, compliance by our customers with the terms of their contracts with us, and other factors disclosed in this quarterly report on Form 10-Q and the annual report on Form 10-K for the year ended December 31, 2005, including Exhibit 99.1 thereto, filed with the SEC on March 15, 2006. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Table of Contents

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

In the ordinary course of its operations, the Company is exposed to certain market risks, primarily interest rates. Uncertainties that are either non-financial or non-quantifiable, such as political, economic, tax, other regulatory or credit risks are not included in the following assessment of the Company's market risks.

Market risks. The Company manages market risk in accordance with its investment guideline objectives, including:

Maximum safety of principal

Maintenance of appropriate liquidity for regular cash needs

Maximum yields in relationship to guidelines and market conditions

Diversification of risks

Fiduciary control of all investments

The Company targets its fixed income investment portfolio to have maturities of 24 months or less. Investments are held to enhance the preservation of capital and not for trading purposes.

Interest rates. Cash equivalents consist of money market accounts with original maturities of less than three months. Short-term investments include obligations of U.S. government agencies and corporate debt securities. Corporate debt securities include commercial paper which must carry minimum short-term ratings of P-1 by Moody's and A-1 by Standard & Poors. Other corporate debt obligations must carry a minimum rating of A-2 by Moody's or A by Standard & Poor's. Asset-backed securities must carry a minimum AAA rating by Moody's and Standard & Poor's with a maximum average life of two years at the time of purchase.

Interest on the Credit Facility, which expired on May 26, 2006, was based on Prime Rate per annum. The Company chose not to renew the Credit Facility upon its expiration. The Company was charged a weighted average interest rate of 6.5% per annum during the first nine months of 2006 under the Credit Facility. As of September 30, 2006, there was no amount outstanding under the Credit Facility's Revolver and \$0.8 million outstanding under the Credit Facility's Equipment Loan, with no future availability to draw on the Equipment Loan and payment of the outstanding balance of such Equipment Loan due on or before December 31, 2008.

As of September 30, 2006, total investments in available-for-sale marketable securities were \$17.6 million. The Company is subject to financial market risks, including changes in interest rates and the valuations of its investment portfolio. Changes in amounts borrowed or interest rates could impact the Company's anticipated interest income from interest-bearing cash accounts, or cash equivalents and investments in marketable securities, as well as interest expense on borrowings under the Credit Facility.

Interest rate risk. As of September 30, 2006, virtually all of the investments in the Company's portfolio were at fixed rates (with a weighted average interest rate of 5.1% per annum). In addition, the Credit Facility is a variable rate borrowing facility.

To illustrate the potential impact of changes in interest rates, the Company has performed the following analysis based on its September 30, 2006 unaudited condensed consolidated balance sheet and assuming no changes in its investment and borrowing structure. Under this analysis, an immediate and sustained 100 basis point increase in the various base rates would result in a decrease in the fair market value of the Company's total portfolio of approximately \$90 thousand over the next 12 months. An immediate and sustained 100 basis point decrease in the various base rates would result in an increase of the fair market value of the Company's total portfolio of approximately \$90 thousand over the next 12 months.

Table of Contents

ITEM 4. Controls and Procedures

(a) *Evaluation of disclosure controls and procedures.* The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer (the CEO) and the Chief Financial Officer (the CFO), of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report pursuant to Exchange Act Rule 13a-15. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and timely reported as specified in the SEC's rules and forms and accumulated and communicated to the Company's management, including the CEO and CFO, to allow timely decisions regarding disclosure. It should be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

(b) *Changes in internal control over financial reporting.* In connection with the evaluation required by Exchange Act Rule 13a-15, the Company's management, including the CEO and CFO, concluded that no changes occurred during the quarter ended September 30, 2006 in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION

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

Issuer Purchases of Equity Securities On October 30, 2000, the Company announced that its Board of Directors authorized the repurchase of up to 1,000,000 shares of the Company's outstanding Common Stock (the Stock Repurchase Plan). Stock repurchases may be made periodically in the open market, in privately negotiated transactions or a combination of both.

For purposes of mitigating the expected dilution created by stock-based compensation, during the fourth quarter of 2005, the Company's Board of Directors authorized the Company to resume repurchasing its Common Stock under the Stock Repurchase Program, commencing in 2006. The Company did not repurchase any shares of its Common Stock under the Stock Repurchase Plan in 2003, 2004 or 2005. As of September 30, 2006, an aggregate of 290,563 shares of Common Stock remained authorized for repurchase under the Stock Repurchase Plan. The extent and timing of these repurchase transactions will depend on market conditions and other business considerations.

Table of Contents

There were 451,790 shares of the Company's Common Stock repurchased during the nine months ended September 30, 2006 but no repurchases made during the nine months ended September 30, 2005. As of September 30, 2006, the Company had purchased 709,437 shares of the Company's Common Stock under the Stock Repurchase Plan. The details of Common Stock repurchases for the nine months ended September 30, 2006 were as follows:

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part Of Publicly Announced Plans or Programs (2)	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
January 1 - 31, 2006				742,353
February 1 - 28, 2006				742,353
March 1 - 31, 2006	43,800	22.84	301,447	698,553
April 1 - 30, 2006				698,553
May 1 - 31, 2006	120,190	22.69	421,637	578,363
June 1 - 30, 2006				578,363
July 1 - 31, 2006				578,363
August 1 - 31, 2006	211,200	20.27	632,837	367,163
September 1 - 30, 2006	76,600	22.63	709,437	290,563
Total	451,790	\$ 22.11	709,437	290,563

(1) All shares were purchased through the publicly announced Stock Repurchase Plan in open-market transactions.

(2) On October 30, 2000, the Company announced that its Board of Directors had authorized a stock repurchase of up to 1,000,000 shares of the Company's

outstanding
Common Stock
pursuant to the
Stock
Repurchase
Plan. The
Company's stock
repurchase
transactions will
be conducted
over an
indefinite period
of time.

ITEM 6. Exhibits

Number	Description
10.37	Lease of Office Space by and between OMERS Realty Corporation CPP Investment Board Real Estate Holdings Inc., and The Ultimate Software Group of Canada, Inc., dated August 22, 2006 *
10.38	Indemnity Agreement between OMERS Realty Corporation CPP Investment Board Real Estate Holdings, Inc., and the Company dated August 22, 2006 *
31.1	Certification Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended
31.2	Certification Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as amended
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as amended

* Filed herewith

Table of Contents

Signatures

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.

The Ultimate Software Group, Inc.

Date: November 8, 2006

By: /s/ Mitchell K. Dauerman
Mitchell K. Dauerman
Executive Vice President, Chief
Financial Officer and Treasurer
(Authorized Signatory and Principal
Financial and Accounting Officer)

37