

ASTEA INTERNATIONAL INC  
Form 10-Q  
November 09, 2006

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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**FORM 10-Q**

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2006

or

Transition Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934.

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: **0-26330**

**ASTEA INTERNATIONAL INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**23-2119058**

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

**240 Gibraltar Road, Horsham, PA**

(Address of principal executive offices)

**19044**

(Zip Code)

Registrant's telephone number, including area code: **(215) 682-2500**

N/A

(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

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As of November 7, 2006, 3,591,185 shares of the registrant's Common Stock, par value \$.01 per share, were outstanding.

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ASTEA INTERNATIONAL INC.

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**PART I - FINANCIAL INFORMATION****Item 1. CONSOLIDATED FINANCIAL STATEMENTS****ASTEIA INTERNATIONAL INC.**  
**CONSOLIDATED BALANCE SHEETS**

	<b>September 30, 2006 (Unaudited)</b>	<b>December 31 2005 (Unaudited)</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 4,361,000	\$ 9,484,000
Restricted cash	225,000	225,000
Receivables, net of reserves of \$108,000 and \$333,000	5,923,000	5,037,000
Prepaid expenses and other	495,000	485,000
Total current assets	11,004,000	15,231,000
Property and equipment, net	518,000	1,038,000
Intangibles, net	1,789,000	1,999,000
Capitalized software, net	3,314,000	2,055,000
Goodwill	1,233,000	1,100,000
Other assets	189,000	189,000
Total assets	\$ 18,047,000	\$ 21,612,000
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 3,895,000	\$ 3,976,000
Deferred revenues	5,950,000	5,767,000
Total current liabilities	9,845,000	9,743,000
Stockholders' equity:		
Preferred stock, \$.01 par value, 5,000,000 shares authorized, none issued	-	-
Common stock, \$.01 par value, 25,000,000 shares authorized, issued 3,591,000 and 3,433,000	36,000	36,000
Additional paid-in capital	27,368,000	27,116,000
Cumulative translation adjustment	(876,000)	(935,000)
Accumulated deficit	(18,118,000)	(14,140,000)
Less: treasury stock at cost, 42,000 and 42,000 shares	(208,000)	(208,000)
Total stockholders' equity	8,202,000	11,869,000
Total liabilities and stockholders' equity	\$ 18,047,000	\$ 21,612,000

**See accompanying notes to the consolidated financial statements.**

**ASTEA INTERNATIONAL INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**

	<b>Three Months</b>		<b>Nine Months</b>	
	<b>Ended September 30,</b>		<b>Ended September 30,</b>	
	<b>2005</b>		<b>2005</b>	
	<b>2006</b>	<b>(Restated)</b>	<b>2006</b>	<b>(Restated)</b>
<b>Revenues:</b>				
Software license fees	\$ 2,212,000	\$ 4,805,000	\$ 3,334,000	\$ 7,471,000
Services and maintenance	4,266,000	3,444,000	11,548,000	9,906,000
<b>Total revenues</b>	<b>6,478,000</b>	<b>8,249,000</b>	<b>14,882,000</b>	<b>17,377,000</b>
<b>Costs and expenses:</b>				
Cost of software license fees	386,000	292,000	1,064,000	875,000
Cost of services and maintenance	2,418,000	2,034,000	7,721,000	5,812,000
Product development	932,000	460,000	2,869,000	1,735,000
Sales and marketing	1,881,000	1,944,000	4,496,000	4,607,000
General and administrative	735,000	771,000	2,893,000	1,967,000
<b>Total costs and expenses</b>	<b>6,352,000</b>	<b>5,501,000</b>	<b>19,043,000</b>	<b>14,996,000</b>
<b>Income (loss) from operations</b>	<b>126,000</b>	<b>2,748,000</b>	<b>(4,161,000)</b>	<b>2,381,000</b>
Interest income, net	48,000	41,000	183,000	90,000
<b>Income (loss) before income taxes</b>	<b>174,000</b>	<b>2,789,000</b>	<b>(3,978,000)</b>	<b>2,471,000</b>
Income tax expense	-	-	-	-
<b>Net income (loss)</b>	<b>\$ 174,000</b>	<b>\$ 2,789,000</b>	<b>\$ (3,978,000)</b>	<b>\$ 2,471,000</b>
Basic income (loss) per share	\$ 0.05	\$ 0.94	\$ (1.12)	\$ 0.84
Diluted income (loss) per share	\$ 0.05	\$ 0.90	\$ (1.12)	\$ 0.80
Shares outstanding used in computing basic income (loss) per share	3,549,000	2,968,000	3,546,000	2,976,000
Shares outstanding used in computing diluted income (loss) per share	3,567,000	3,106,000	3,546,000	3,072,000

**See accompanying notes to the consolidated financial statements.**

**ASTEA INTERNATIONAL INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

	<b>Nine Months</b>	
	<b>Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
		<b>(Restated)</b>
<b>Cash flows from operating activities:</b>		
Net (loss) income	\$ (3,978,000)	\$ 2,471,000
Adjustments to reconcile net (loss) income to net cash (used) provided by operating activities:		
Depreciation and amortization	1,737,000	1,032,000
Increase in allowance for doubtful accounts	209,000	387,000
Compensation expense FAS 123(R)	233,000	-
Changes in operating assets and liabilities:		
Receivables	(955,000)	666,000
Prepaid expenses and other	-	(61,000)
Accounts payable and accrued expenses	(77,000)	810,000
Deferred revenues	191,000	(742,000)
Other assets	2,000	(11,000)
Net cash (used) provided by operating activities	(2,638,000)	4,552,000
<b>Cash flows from investing activities:</b>		
Reduction in restricted cash	-	75,000
Purchases of property and equipment	(106,000)	(213,000)
Net cash from acquisition of FieldCentrix	-	616,000
Capitalized software development costs	(2,139,000)	(826,000)
Increase in goodwill	(133,000)	-
Net cash used in investing activities	(2,378,000)	(348,000)
<b>Cash flows from financing activities:</b>		
Proceeds from exercise of stock options and employee stock purchase plan	19,000	34,000
Cash flow from financing activities	19,000	34,000
Effect of exchange rate changes on cash	(126,000)	80,000
Net (decrease) increase in cash and cash equivalents	(5,123,000)	4,318,000
Cash, beginning of period	9,484,000	4,483,000
Cash and cash equivalents balance, end of period	\$ 4,361,000	\$ 8,801,000

**See accompanying notes to the consolidated financial statements.**



**Item 1. CONSOLIDATED FINANCIAL STATEMENTS (Continued)****ASTEAL INTERNATIONAL INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****1. BASIS OF PRESENTATION**

The consolidated financial statements at September 30, 2006 and for the three and nine month periods ended September 30, 2006 and 2005 of Astea International Inc. and subsidiaries ("Astea" or the "Company") are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial position and operating results for the interim periods. The consolidated financial statements should be read in conjunction with the notes thereto, together with Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in this Form 10-Q and in the Company's 2005 Annual Report on Form 10-K which are hereby incorporated by reference in this quarterly report on Form 10-Q. Results of operations and cash flows for the nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the full year.

**2. STOCKHOLDERS' EQUITY/COMPREHENSIVE INCOME**

The reconciliation of stockholders' equity and comprehensive loss from December 31, 2005 to September 30, 2006 is summarized as follows:

	<b>Common Stock</b>	<b>Additional Paid-In Capital</b>	<b>Cumulative Currency Translation Adjustment</b>	<b>Accumulated Deficit</b>	<b>Treasury Stock</b>	<b>Comprehensive Income (loss)</b>
Balance at December 31, 2005	\$ 36,000	\$ 27,116,000	\$ (935,000)	\$ (14,140,000)	\$ (208,000)	-
Exercise of stock options		19,000	-	-	-	-
Compensation Costs FAS123(R)		233,000				
Cumulative translation adjustment	-	-	59,000	-	-	59,000
Net (loss) for the period	-	-	-	(3,978,000)	-	(3,978,000)
Balance at September 30, 2006	\$ 36,000	\$ 27,368,000	\$ (876,000)	\$ (18,118,000)	\$ (208,000)	\$ (3,919,000)

**3. INCOME TAX EXPENSE**

At September 30, 2006, the Company maintains a 100% valuation allowance for its remaining net deferred tax assets based on the uncertainty of the realization of future taxable income.

**4. STOCK BASED COMPENSATION**

On January 1, 2006, the Company adopted the fair value recognition provisions of FAS 123(R) using the modified prospective transition method. Under this method, compensation costs recognized in the first nine months of 2006 include (a) compensation costs for all share-based payments granted prior to, but not yet vested as of January 1, 2006,



based on the grant date value estimated in accordance with the original provisions of FAS (123) and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of FAS 123(R). Results for prior periods have not been restated.

Under the Company's stock option plans, option awards generally vest over a four year period of continuous service and have a 10 year contractual term. The fair value of each option is amortized on a straight-line basis over the option's vesting period. The fair value of each option is estimated on the date of the grant using the Black-Scholes option valuation model and the following weighed average assumptions for the nine months ending September 30, 2006.

	<b>Nine Months Ended September 30, 2006</b>
Weighted-average fair value	\$ 6.96
Risk-free interest rate	4.95%
Expected life (in years)	6
Volatility	116%
Expected dividends	-

Expected volatility is based on historical volatility of the Company's stock and comparable peer data. The expected life of options granted is estimated on historical option exercise and employee termination data. Executive level employees who hold a majority of the options outstanding, and non-executive level employees were each found to have similar historical option exercise and termination behavior and thus were grouped for valuation purposes. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

The following table illustrates the effect on the net income and earnings per share if the Company had applied the fair value recognition provisions for FAS 123 to options granted under the Company's stock option plain in all periods presented.

	<b>Three Months Ended September 30, 2005 (as Restated)</b>	<b>Nine Months Ended September 30, 2005 (as Restated)</b>
Net income - as reported	\$ 2,789,000	\$ 2,471,000
Add: Stock-based compensation included in net income as reported, net or related tax effects	-	-
Deduct stock-based compensation determined under fair value based methods for all awards, net of related tax effects	(132,000)	(248,000)
Net income - pro forma	\$ 2,657,000	\$ 2,223,000
Basic income per share - as reported	\$ 0.94	\$ 0.84
Diluted income per share as Reported	\$ 0.90	\$ 0.80
Basic income per share - pro forma	\$ 0.90	\$ 0.75
Diluted income per share pro Forma	\$ 0.86	\$ 0.72



For purposes of this proforma disclosure, the fair value of each option is amortized on a straight-line basis over the option's vesting period. The fair value of each option is estimated on the date of grant using the Black-Scholes option valuation model and the following weighted-average assumptions for the quarter ending September 30, 2005:

	<b>Nine Months Ended September 30, 2005</b>
Weighted-average fair value	\$ 6.43
Risk-free interest rate	4.32%
Expected life (in years)	6
Volatility	118%
Expected Dividends	-

As of September 30, 2006, the total unrecognized compensation cost related to non-vested options granted amounted to \$862,000, which is expected to be recognized over the options' remaining vesting period which could be as long as four years. No income tax benefit was realized by the Company in the nine months ended September 30, 2006 as the Company reported an operating loss.

Activity under the Company's stock option plan is as follows:

	<b>Options Available for Grant</b>	<b>Number of Options Outstanding</b>	<b>Weighted Average Price per Share</b>
Balance at December 31, 2005	35,822	291,664	\$ 7.04
Options authorized	350,000		-
Options granted	(160,000)	160,000	\$ 8.14
Options exercised	-	(6,000)	\$ 3.23
Options cancelled:			
Options forfeited	98,200	(100,200)	\$ 7.26
Options expired	(800)	-	-
Balance at September 30, 2006	323,222	345,464	\$ 7.12

During the second quarter of 2006, the shareholders of the Company approved the 2006 Stock Option Plan in order to fulfill the Company's needs of attracting new managerial and technical talent and retaining existing talent. The 2006 plan authorizes the issuance of a maximum of 350,000 shares of Common Stock of the Company.

During the three month period ended September 30, 2006 no options were exercised.

The following table summarizes outstanding options that are vested and expected to vest and options under the Company's stock option plans as of September 30, 2006.

	<b>Number of Shares</b>	<b>Weighted Average Price Per Share</b>	<b>Weighted Average Remaining Contractual Term (in years)</b>	<b>Aggregate Intrinsic Value</b>
Outstanding Options (vested and expected to vest)	345,464	\$ 7.12	7.15	\$ 1,894,617

Options Exercisable	111,041	\$	6.79	8.10	\$	563,951
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5. LINE OF CREDIT

On May 26, 2006 the Company entered into a secured revolving line of credit (Line) agreement with a bank. Maximum available borrowings under the Line represent the lesser of 80% of the Borrowing Base, which is defined as Eligible Accounts Receivables, or \$4.0 million. Amounts outstanding on the line of credit were zero on September 30, 2006.

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The Line bears interest at the Line Interest Rate, as defined by the agreement. The Line provides for payment of a quarterly commitment fee of .25% per annum on the unused portion of the maximum commitment, which can be as high as \$2,500.

Borrowings under the Line are collateralized by all the Company's assets.

## 6. MAJOR CUSTOMERS

In the third quarter of 2006, there was one major customer that accounted for 10% of total revenues. In the third quarter of 2005, the Company had one customer that accounted for 55% of its total revenue. For the first nine months of 2006 no customer accounted for 10% or more of total revenues and for the first nine months of 2005, there were two customers that accounted for 27% and 12% of total revenues.

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

### Overview

This document contains various forward-looking statements and information that are based on management's beliefs, assumptions made by management and information currently available to management. Such statements are subject to various risks and uncertainties, which could cause actual results to vary materially from those contained in such forward-looking statements. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated, expected or projected. Certain of these, as well as other risks and uncertainties are described in more detail herein and in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

Astea is a global provider of service management software that addresses the unique needs of companies who manage capital equipment, mission critical assets and human capital. Clients include Fortune 500 to mid-size companies, which Astea services through company facilities in the United States, United Kingdom, Australia, The Netherlands, and Israel. Since its inception in 1979, Astea has licensed applications to companies in a wide range of sectors including information technology, telecommunications, instruments and controls, business systems, and medical devices.

As a leading provider of service management solution, Astea has been helping companies across the globe achieve the highest level of customer satisfaction with faster response time and proactive communication. The result is a consistent and highly personalized experience at every touch point. Currently, Astea markets and sells Astea Alliance service management suite, FX Enterprise, FX Mobile and FX Service Center. Astea Alliance synchronizes and optimizes critical business processes for contact center, field service, depot repair, logistics, professional service and sales and marketing. The application suite is extended with portal, business intelligence, dynamic scheduling and mobile solutions. FX Enterprise, FX Mobile and FX Service Center are designed to help companies better manage their mobile workforce in the field.

Marketing and sales of licenses, services and maintenance related to the Company's legacy system DISPATCH-1® products are limited to existing DISPATCH-1 customers.

### *FieldCentrix*

On September 21, 2005, the Company, through a wholly owned subsidiary, FC Acquisition Corp., acquired substantially all of the assets of FieldCentrix, Inc, the industry's leading mobile field force automation company. FieldCentrix develops and markets mobile field service automation (FSA) systems, which include the wireless

dispatch and support of mobile field technicians using portable, hand-held computing devices. The FieldCentrix offering has evolved into a leading complementary service management solution that runs on a wide range of mobile devices (handheld computers, laptops and PC's, and Pocket PC devices), and integrates seamlessly with popular CRM and ERP applications. FieldCentrix has licensed applications to Fortune 500 and mid-size companies in a wide range of sectors including HVAC, building and real estate services, manufacturing, process instruments and controls, and medical equipment.

### Critical Accounting Policies and Estimates

The Company's significant accounting policies are more fully described in its Summary of Accounting Policies, Note 2 to the Company's year-end consolidated financial statements. The preparation of financial statements in conformity with accounting principles generally accepted within the United States requires management to make estimates and assumptions in certain circumstances that affect amounts reported in the accompanying financial statements and related notes. In preparing these financial statements, management has made its best estimates and judgments of certain amounts included in the financial statements, giving due consideration to materiality. The Company does not believe there is a great likelihood that materially different amounts would be reported related to the accounting policies described below; however, application of these accounting policies involves the exercise of judgments and the use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates.

#### *Revenue Recognition*

Revenues are recognized in accordance with Statement of Position (SOP) 97-2, which provides guidelines on the recognition of software license fee revenue. Principally, revenue may be recognized when persuasive evidence of an arrangement exists, delivery has occurred, the license fee is fixed and determinable and the collection of the fee is probable. The Company allocates a portion of its software revenue to post-contract support activities or to other services or products provided to the customer free of charge or at non-standard discounts when provided in conjunction with the licensing arrangement. Amounts allocated are based upon standard prices charged for those services or products. Software license fees for resellers or other members of the indirect sales channel are based on a fixed percentage of the Company's standard prices. The Company recognizes software license revenue for such contracts based upon the terms and conditions provided by the reseller to its customer.

Revenue from post-contract support is recognized ratably over the term of the contract on a straight-line basis. Consulting and training service revenue is generally recognized at the time the service is performed. Fees from licenses sold together with consulting services are generally recognized upon shipment, provided that the contract has been executed, delivery of the software has occurred, fees are fixed and determinable and collection is probable. In instances where the aforementioned criteria have not been met, both the license and the consulting fees are recognized under the percentage of completion method of contract accounting.

In limited instances, the Company will enter into contracts for which revenue is recognized under contract accounting. The accounting for such arrangements requires judgment, which impacts the timing of revenue recognition and provision for estimated losses, if applicable.

#### *Accounts Receivable*

The Company evaluates the adequacy of its allowance for doubtful accounts at the end of each quarter. In performing this evaluation, the Company analyzes the payment history of its significant past due accounts, subsequent cash collections on these accounts and comparative accounts receivable aging statistics. Based on this information, along with consideration of the general strength of the economy, the Company develops what it considers to be a reasonable estimate of the uncollectible amounts included in accounts receivable. This estimate involves significant judgment by the management of the Company. Actual uncollectible amounts may differ from the Company's estimate.

#### *Capitalized Software Research and Development Costs*

The Company does account for its internal software development costs in accordance with Statement of Financial Accounting Standards ("SFAS") No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed." The Company capitalizes software development costs subsequent to the establishment of technological feasibility through the products availability for general release. Costs incurred prior to the establishment



of technological feasibility are charged to product development expense. Development costs associated with product enhancements that extend the original product's life or significantly improve the original products marketability are also capitalized once technological feasibility has been established. Software development costs are amortized on a product-by-product basis over the greater of the ratio of current revenues to total anticipated revenues or on a straight-line basis over the estimated useful lives of the products (usually two years), beginning with the initial release to customers. The Company continually evaluates whether events or

circumstances have occurred that indicate that the remaining useful life of the capitalized software development costs should be revised or that the remaining balance of such assets may not be recoverable. The Company evaluates the recoverability of capitalized software based on the estimated future revenues of each product. As of September 30, 2006, management believes that no revisions to the remaining useful lives or write-downs of capitalized software development costs are required.

### *Goodwill*

On September 30, 2005, the Company acquired the assets and certain liabilities of FieldCentrix, Inc. through its wholly-owned subsidiary, FC Acquisition Corp. Included in the allocation of the purchase price was goodwill valued at \$1,100,000 at December 31, 2005. The Company tests goodwill for impairment annually during the first quarter of each fiscal year at the reporting unit level using a fair value approach, in accordance with the provision SFAS No. 142, *Goodwill and Other Intangible Assets*. If an event occurs or circumstances change that would be more likely than not to reduce the fair value of a reporting unit below its carrying value, goodwill will be evaluated for impairment between annual tests.

The purchase price agreement to acquire the assets of FieldCentrix includes earnout provisions to pay the sellers a percentage of certain future license sales and professional service revenue through June 30, 2007. Accordingly, future amounts paid under the earnout provisions will be added to goodwill when such sales occur. In the nine months ended September 30, 2006, goodwill was increased \$133,000 to \$1,233,000 due to the adjustment on contingent payments due to the sellers of the assets of FieldCentrix, Inc.

### Results of Operations

#### Comparison of Three Months Ended September 30, 2006 and 2005

#### Revenues

Revenues decreased \$1,771,000, or 21%, to \$6,478,000 for the three months ended September 30, 2006 from \$8,249,000 for the three months ended September 30, 2005. Software license fee revenues decreased \$2,593,000 or 54%, from the same period last year. Services and maintenance fees for the three months ended September 30, 2006 increased 24 % to \$4,266,000, from \$3,444,000 from the same quarter in 2005.

The Company's international operations contributed \$1,258,000 of revenues in the third quarter of 2006, which was a 78% decrease from revenues generated during the third quarter of 2005. The Company's revenues from international operations amounted to 19% of the total revenue for the third quarter in 2006 compared to 68% of total revenues for the same quarter in 2005.

Software license fee revenues decreased 54% to \$2,212,000 in the third quarter of 2006 from \$4,805,000 in the third quarter of 2005. Astea Alliance license revenues decreased \$3,325,000 or 69%, to \$1,480,000 in the third quarter of 2006 from \$4,804,000 in the third quarter of 2005. The decrease is attributable to one major sale to a customer in 2005 that accounted for 55% of total revenue in the third quarter of 2005. The Company sold \$733,000 of software licenses from its recently acquired FieldCentrix subsidiary compared to \$0 in the same period last year.

Services and maintenance revenues increased to \$4,266,000 in the third quarter of 2006 from \$3,444,000 in the third quarter of 2005. The Astea Alliance service and maintenance revenues increased by \$334,000 or 11% compared to the third quarter of 2005. This increase was partially offset by an \$85,000 decrease in DISPATCH-1 service and maintenance revenues, which resulted from an expected decrease in demand. Additionally, FieldCentrix contributed \$687,000 in services and maintenance revenue during the third quarter of 2006, compared to \$113,000 the same quarter of last year after the Company acquired the business on September 21, 2005.

Costs of Revenues

Cost of software license fees increased 32% to \$386,000 in the third quarter of 2006 from \$292,000 in the third quarter of 2005. Included in the cost of software license fees is the fixed cost of capitalized software amortization. The principle cause of the increase is the amortization of software acquired from FieldCentrix which was not a part of the Company's expense during the same period of 2005 and certain third party software costs associated with license sales this quarter. The gross margin on software license sales was 83% in the third quarter of 2006

compared to 94% in the third quarter of 2005. The decline in gross margin was attributable to both a decrease in license revenue from the same period in 2005 and an increase in the cost of software licenses sold.

Cost of services and maintenance increased 19% to \$2,418,000 in the third quarter of 2006 from \$2,034,000 in the third quarter of 2005. The increase in cost of service and maintenance is primarily attributed to an increase in professional services staff from last year to this year plus the addition of the FieldCentrix professional services staff and the recruiting costs associated with those hires. The services and maintenance gross margin percentage was 43% in the third quarter of 2006 compared to 41% in the third quarter of 2005. The slight increase in services and maintenance gross margin was primarily due to the increase in maintenance revenue, which generally has higher profit margins.

#### Product Development

Product development expense increased 103% to \$932,000 in the third quarter of 2006 from \$460,000 in the third quarter of 2005. The increase results from the Company's ongoing program of improving product quality and the expansion of the development staff, principally through the addition of FieldCentrix development activities. The Company excludes capitalized software development costs from product development expense. Software development costs of \$737,000 were capitalized in the third quarter of 2006 compared to \$437,000 during the same period in 2005. Gross development expense before capitalization was \$1,669,000 and \$897,000 for the quarters ending September 30, 2006 and 2005, respectfully. The increase results from development efforts for both the next Astea Alliance release and development of FieldCentrix products. Product development expense as a percentage of revenues was 14% in the third quarter of 2006 compared to 6% in the third quarter of 2005.

#### Sales and Marketing

Sales and marketing expense decreased 3% to \$1,881,000 in the third quarter of 2006 from \$1,944,000 in the third quarter of 2005. The decrease in sales and marketing expense is attributable to a reduction in headcount in sales staffing costs, as well as lower commission expenses related to the decrease of license sales from the same period in 2005. As a percentage of revenues, sales and marketing expenses increased to 29% in 2006 from 24% in the third quarter of 2005.

#### General and Administrative

General and administrative expenses decreased 5% to \$735,000 during the third quarter of 2006 from \$771,000 in the third quarter of 2005. The decrease in general and administrative expenses is due to a decrease in the Company's bad debt expense. In addition, the Company incurred indirect operating costs in connection to the FieldCentrix acquisition during the third quarter of 2005, primarily professional fees and travel. As a percentage of revenue, general and administrative expenses increased to 11% in the third quarter of 2006 from 9% in the third quarter of 2005.

#### Interest Income, Net

Net interest income increased \$7,000 to \$48,000 in the third quarter of 2006 from \$41,000 in the third quarter of 2005. The increase in interest income is generally attributable to an increase in the level of investments as well as higher interest rates earned on the Company's portfolio of invested funds.

#### International Operations

Total revenue from the Company's international operations decreased during the third quarter of 2006 to \$1,259,000 compared to \$5,640,000 for the third quarter of 2005. The decrease in revenue from international operations was primarily attributable to a very large sale that occurred in 2005 that accounted for 55% of the Company's total

revenues and was not repeated in 2006. International operations generated a net loss of \$135,000 for the third quarter ended September 30, 2006 compared to net income of \$2,022,000 in the same quarter in 2005.

Comparison of Nine Months Ended September 30, 2006 and 2005

Revenues

Revenues decreased \$2,495,000, or 14%, to \$14,882,000 for the nine months ended September 30, 2006 from \$17,377,000 for the nine months ended September 30, 2005. Software license fee revenues decreased \$4,137,000, or 55%, from the same period last year. Services and maintenance fees for the nine months ended September 30, 2006 amounted to \$11,548,000, a 17% increase from the same quarter in 2005.

The Company's international operations contributed \$3,954,000 of revenues in the first nine months of 2006 compared to \$9,108,000 in the first nine months of 2005. This represents a 57% decrease from the same period last year. The decrease in revenues is due to the decrease in sales from the Company's foreign operations, primarily in Europe which accounted for one significant sale that represented 52% of the Company's revenue.

Software license fee revenues decreased 55% to \$3,334,000 in the first nine months of 2006 from \$7,471,000 in the first nine months of 2005. The decrease is primarily attributable to lower license sales during the first nine months of 2006 including one significant sale that represented 52% of revenue during the first nine months of 2005. Astea Alliance license revenues decreased \$5,145,000 or 69% in the first nine months of 2006 from \$7,455,000 in the first nine months of 2005. Partially offsetting the decline were \$1,027,000 of software licenses from the Company's newly acquired subsidiary, FieldCentrix. There were no DISPATCH-1 license revenue during the first nine months of 2006 compared to \$16,000 for the same period in 2005.

Services and maintenance revenues increased 17% to \$11,548,000 in the first nine months of 2006 from \$9,906,000 in the first nine months of 2005. The increase primarily relates to service and maintenance revenues of \$2,123,000 from FieldCentrix which was acquired on September 21, 2005, compared to \$113,000 in 2005. Slightly offsetting this increase were declines of \$326,000 in DISPATCH-1 service and maintenance and \$44,000 in Astea Alliance service and maintenance.

Costs of Revenues

Cost of software license fees increased 22% to \$1,064,000 in the first nine months of 2006 from \$875,000 in the first nine months of 2005. Included in the cost of software license fees is the fixed cost of capitalized software amortization. The principal cause of the increase is the amortization of software acquired from FieldCentrix which was not a part of the Company's expenses during the same period in 2005 and third party license costs included in certain licenses sold in 2006. The software license gross margin percentage was 68% in the first nine months of 2006 compared to 88% during the same period in 2005. The decrease in gross margin was attributable to both the decrease in license sales and the increase in the cost of software license fees.

Cost of services and maintenance increased 33% to \$7,721,000 in the first nine months of 2006 from \$5,812,000 in the first nine months of 2005. The increase in cost of service and maintenance is primarily attributed to an increase in headcount from last year to this year, including the addition of FieldCentrix staff. The services and maintenance gross margin percentage was 33% in the first nine months of 2006 compared to 41% in the first nine months of 2005. The decline in gross margin from professional services and maintenance is principally due to lower utilization of the professional staff, resulting from a large investment in product quality assurance activities during the first nine months of 2006.

Product Development

Product development expense increased 65% to \$2,869,000 in the first nine months of 2006 from \$1,735,000 in the first nine months of 2005. The increase results from the Company's ongoing program of improving product quality,

increasing product functionality and the addition of FieldCentrix development activities. The Company excludes capitalized software costs from product development expense. Software development costs of \$2,139,000 were capitalized in the first nine months of 2006 compared to \$826,000 during the same period in 2005. The increase results from development efforts for the next Astea Alliance release and upgrades to FieldCentrix products. Product development as a percentage of revenues was 19% in the first nine months of 2006 compared with 10% in the first nine months of 2005. Gross product development expenses were \$5,008,000 in the first nine months of 2006, compared to \$2,561,000 of gross development expense in 2005. The increase in cost is due to the continued effort

of the Company to improve the quality and functionality of its product, which required adding more development staff. Additionally, the Fieldcentrix acquisition increased the Company's development staff and costs.

#### Sales and Marketing

Sales and marketing expense decreased 2% to \$4,496,000 in the first nine months of 2006 from \$4,607,000 in the first nine months of 2005. The decrease in sales and marketing costs is attributable to lower sales commissions paid in the first nine months of 2006 due to lower license revenues. As a percentage of revenues, sales and marketing expenses increased slightly to 30% from 27% from the first nine months of 2005.

#### General and Administrative

General and administrative expenses increased 47% to \$2,893,000 in the first nine months of 2006 from \$1,967,000 in the first nine months of 2005. The increase in general and administrative expenses is attributable to \$457,000 in administrative costs connected with the operation of FieldCentrix, \$200,000 associated with the insurance retention of the class action lawsuit, \$115,000 increase in executive compensation, \$50,000 in outside consulting and \$63,000 in taxes unrelated to income. As a percentage of revenues, general and administrative expenses increased to 19% from 11% in the first nine months of 2005.

#### Interest Income, Net

Net interest income increased \$93,000 from \$90,000 in the first nine months of 2005 to \$183,000 in the first nine months of 2006. The increase resulted primarily from an increase in the amount of investments as well as higher interest rates paid on the Company's portfolio of invested funds.

#### International Operations

Total revenue from the Company's international operations decreased by \$5,154,000, or 57%, to \$3,954,000 in the first nine months of 2006 from \$9,108,000 in the first nine months in 2005. International operations generated a net loss of \$772,000 for the first nine months ended September 30, 2006 compared to income of \$2,288,000 in the same period in 2005. The principal cause of the decline in revenue and income was one large license sale in 2005 that accounted for 52% of the Company's license revenue.

#### Liquidity and Capital Resources

Net cash used in operating activities was \$2,638,000 for the nine months ended September 30, 2006 compared to net cash provided by operating activities of \$4,552,000 for the nine months ended September 30, 2005, a change of \$7,190,000. The largest component accounting for the change in cash used was a \$6,449,000 change from net income of \$2,471,000 earned during the first nine months of 2005 compared to a loss of \$3,978,000 in the first nine months of 2006. In addition, accounts receivable increased by \$955,000 in 2006 compared to a decrease of \$666,000 in 2005. Accounts payable decreased by \$77,000 in 2006 compared to an increase of \$810,000 in 2005. Partially offsetting the use of cash is an increase of \$705,000 in depreciation and amortization in 2006, resulting primarily from the additional depreciable assets acquired from FieldCentrix, \$234,000 in non-cash compensation expense related to accounting for the cost of stock options and an increase of \$191,000 in deferred revenues compared to a decrease of \$742,000 in 2005.

The Company used \$2,378,000 for investing activities in the first nine months of 2006 compared to using \$348,000 in the first nine months of 2005. The principal reason for the increase is \$1,313,000 of increased capitalized software development costs, \$133,000 in additional goodwill resulting from contingent payments associated with the acquisition of FieldCentrix as well as \$661,000 of cash received last year as part of the FieldCentrix acquisition.



The Company generated \$19,000 of cash from financing activities during the nine months ended September 30, 2006 compared to \$34,000 for the same period in 2005 both resulting in the exercise of stock options during the respective periods.

At September 30, 2006, the Company had a working capital ratio of 1.12:1, with cash, cash equivalents and restricted cash of \$4,586,000. The Company believes that it has adequate cash resources to make the investments necessary to maintain or improve its current position and to sustain its continuing operations for the next twelve

months. The Board of Directors from time to time reviews the Company's forecasted operations and financial condition to determine whether and when payment of a dividend or dividends is appropriate. The Company does not anticipate that its operations or financial condition will be affected materially by inflation.

#### Variability of Quarterly Results and Potential Risks Inherent in the Business

The Company's operations are subject to a number of risks, which are described in more detail in the Company's prior SEC filings, including in its annual report on Form 10-K for fiscal year ended December 31, 2005. Risks which are peculiar to the Company on a quarterly basis, and which may vary from quarter to quarter, include but are not limited to the following:

- The Company's quarterly operating results have in the past varied and may in the future vary significantly depending on factors such as the size, timing and recognition of revenue from significant orders, the timing of new product releases and product enhancements, and market acceptance of these new releases and enhancements, increases in operating expenses, and seasonality of its business.
- The market price of the Company's common stock could be subject to significant fluctuations in response to, and may be adversely affected by, variations in quarterly operating results, changes in earnings estimates by analysts, developments in the software industry, adverse earnings or other financial announcements of the Company's customers and general stock market conditions, as well as other factors.

#### **Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

Market risk represents the risk of loss that may impact the Company's financial position due to adverse changes in financial market prices and rates. The Company's market risk exposure is primarily a result of fluctuations in interest rates and foreign currency exchange rates. The Company does not hold or issue financial instruments for trading purposes.

*Interest Rate Risk.* The Company's exposure to market risk for changes in interest rates relate primarily to the Company's investment portfolio. The Company does not have any derivative financial instruments in its portfolio. The Company places its investments in instruments that meet high credit quality standards. The Company is adverse to principal loss and ensures the safety and preservation of its invested funds by limiting default risk, market risk and reinvestment risk. As of September 30, 2006, the Company's investments consisted of U.S. government commercial paper. The Company does not expect any material loss with respect to its investment portfolio. In addition, the Company does not believe that a 10% change in interest rates would have a significant effect on its interest income.

*Foreign Currency Risk.* The Company does not use foreign currency forward exchange contracts or purchased currency options to hedge local currency cash flows or for trading purposes. All sales arrangements with international customers are denominated in foreign currency. For the three month period ending September 30, 2006, approximately 19% of the Company's overall revenue resulted from sales to customers outside the United States. A 10% change in the value of the U.S. dollar relative to each of the currencies of the Company's non-U.S.-generated sales would not have resulted in a material change to its results of operations. The Company does not expect any material loss with respect to foreign currency risk.

#### **Item 4. CONTROLS AND PROCEDURES**

##### Evaluation of disclosure controls and procedures

Our management, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures, as such

phrase is defined under Rule 13Aa-15(e) promulgated under the Securities and Exchange Act of 1934, related to our reporting and disclosure obligations as of September 30, 2006, which is the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are sufficient to provide that (a) material information relating to us, including our consolidated subsidiaries, is made known to these officers by our and our consolidated subsidiaries other employees, particularly material information related to the period for which

this periodic report is being prepared; and (b) this information is recorded, processed, summarized, evaluated and reported, as applicable, within the time periods specified in the rules and forms promulgated by the Securities and Exchange Commission.

Except as noted below, there have been no significant changes in the Company's internal controls over financial reporting during the most recently completed fiscal quarter that materially affected, or are reasonably likely to materially affect, its internal controls over reporting.

Management has concluded that the Company needed to adjust certain internal controls to ensure that accounting for capitalized software development costs was correctly applied pursuant to generally accepted accounting principles. Specifically, the Company had overcapitalized software development costs and restated its financial results in April 2006 for quarters ended March 31, 2005, June 30, 2005 and September 30, 2005. Management has determined that this process did not constitute a material weakness in internal controls over financial reporting as of December 31, 2005.

Management has revised the Company's internal reporting policies and procedures in order to meet the standard of capitalized software development cost under FAS No. 86 by expanding the Company's internal reporting procedures. By implementing these internal control improvements, management has refined the reporting process for the first quarter of 2006.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings**

#### **Purported Shareholder Class Action and Derivative Lawsuit**

On and shortly after April 6, 2006, certain purported shareholder class action and derivative lawsuits were filed in the United States District Court for the Eastern District of Pennsylvania against the Company and certain of its directors and officers. The lawsuits, alleging that the Company and certain of its officers and directors violated federal securities laws and state laws, relate to the company's March 31, 2006 announcement of the accounting restatement for overcapitalized software development costs during the first two quarters of 2005 and undercapitalized software development costs during the third quarter of 2005. Pursuant to a Stipulation and Order of the Court entered July 12, 2006, the putative class actions were consolidated, certain persons were appointed as lead plaintiffs, and a consolidated amended complaint was filed on September 11, 2006. The defendants filed a motion to dismiss the consolidated amended complaint on October 26, 2006, and the Court will decide this motion once briefing has been completed. On September 14, 2006, the Court consolidated the putative derivative actions, appointed certain persons to serve as co-lead plaintiffs, and ordered co-lead plaintiffs to file a consolidated amended derivative complaint within thirty (30) days after a decision is rendered on defendants' motion to dismiss the consolidated class action.

The Company believes these lawsuits are without merit and intends to defend them vigorously

### **Item 1A. Risk Factors**

In addition to the other information set forth in this report, including the risk factors set forth below, you should carefully consider the factors discussed in Part 1, "Item 1A Risk Factors" in the Company's Annual Report on Form 10-k for the year ended December 31, 2005, which could materially affect the Company's business, financial condition or future results. The risks described in this report and in the Company's Annual Report on Form 10-k for the year ended December 31, 2005 are not the only risks facing the Company. Additional risks and uncertainties not currently known to the Company or that the Company currently deems to be immaterial also may materially adversely affect the Company's business, financial condition and/or operating results.

We are subject to a pending civil litigation action and which, if decided against us or as a result of settlement, could require us to pay substantial judgments, settlements, fines or other penalties, and we cannot predict the timing of developments in this litigation.

The Company is currently subject to pending civil litigation, which may become time consuming, expensive and distracting from the conduct of the Company's daily business. The Company is unable at this time to estimate what its ultimate liability in this matter may be, and it is possible that it will be required to pay substantial judgments, settlements, fines or other penalties and incur expenses that could have a material adverse effect on the Company's business, results of operations and/or financial condition, and such effects could be very significant. Although the Company maintains certain insurance coverage, a substantial amount of any such payments may not be covered by insurance. Expenses incurred in connection with these matters (which include substantial fees of lawyers and other professional advisors and potential obligations to indemnify officers and directors who may be parties to such actions) could adversely affect the Company's cash position. The Company recorded a charge during the second quarter 2006 of \$200,000 for pending litigation as it relates to the Company's insurance deductible. The Company has not taken any additional reserves for any potential judgments, settlements, fines or other penalties that may arise from this litigation. The Company cannot predict the timing of developments in respect of this litigation. For additional information related to this litigation, see the "Legal Proceedings" section of this report on Form 10-Q.

**Item 6. Exhibits and Reports on Form 8-K**

(A) Exhibits

31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - CEO and Principal Executive Officer

31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - CFO and Principal Financial and Chief Accounting Officer

32.1 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 - President and Principal Executive Officer

32.2 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 - CFO and Principal Financial and Chief Accounting Officer

(B) Reports on Form 8-K

On August 11, 2006, the Company filed a report on Form 8-K with respect to the press release issued as of that date reporting the results for the six months ended June 30, 2006.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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 this 9th day of November 2006.

ASTEA INTERNATIONAL  
INC.

By: /s/Zack Bergreen  
Zack Bergreen  
Chief Executive Officer  
(Principal Executive  
Officer)

By: /s/Fredric Etskovitz  
Fredric Etskovitz  
Chief Financial Officer  
(Principal Financial and  
Chief  
Accounting Officer)

Exhibit Descriptions

- 31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - CEO and Principal Executive Officer  
31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - CFO and Principal Financial and Chief Accounting Officer
- 32.1 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 - President and Principal Executive Officer  
32.2 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 - CFO and Principal Financial and Chief Accounting Officer